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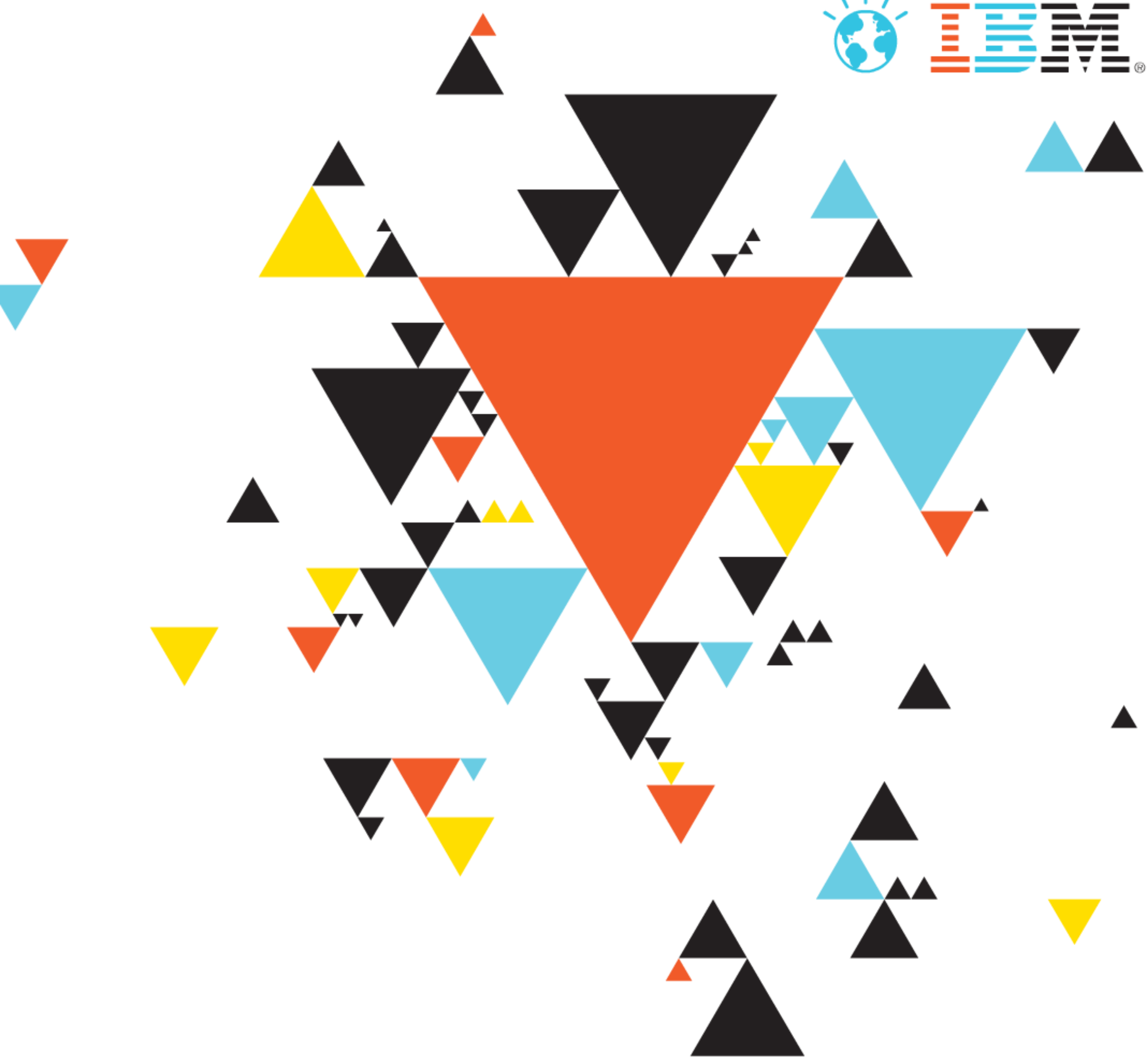
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Jones Day's Noel Francisco (left) and Mike Carvin

THESE MEN COULD KILL SARBOX

040 | Two tenacious Washington lawyers are mounting a serious challenge to the Sarbanes-Oxley Act, the 2002 law that imposed tough restrictions on American businesses. | BW |

IN DEPTH

THE NEW THREAT FROM WALL STREET

034 | During the boom, cities across the U.S. swallowed the bait when offered complex financial products. Now they owe billions in fees to UBS, Goldman Sachs, and other big banks. | BW |

CHILE: PROSPERITY—AND PROBLEMS

044 | Despite decades of economic growth and political stability, many Chileans are feeling a malaise—and the country's ruling center-left coalition may pay the price. | BW |

in INNOVATION GOES DOWNTOWN

050 | The prototypical low-rise, suburban science park isn't the model anymore. From Seoul to Barcelona, urban parks are luring the best minds and the industries of tomorrow. | BW |

(COVER) ILLUSTRATION BY TOMER HANUKA; (THIS PAGE) PHOTOGRAPH BY STEPHEN VOSS

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IS CISCO OVERREACHING?

CEO John Chambers, struggling to show how his $36 billion tech behemoth can remain a growth company, is racing into new markets, battling with IBM, HP, and Dell, and revamping management. Is he trying to do too much? BW | PAGE 026



WHY DRUGMAKERS DON'T TWITTER

The Web is awash in health discussions, but the FDA so far has no guidelines for Pharma to participate. BW | PAGE 064

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(L TO R) ERIC MILLETTE; JACK BLACK

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THE BUSINESS WEEK

EDITED BY HARRY MAURER & CRISTINA LINDBLAD

ECONOMICS & POLICY

OBAMA IN CHINA

Long on theater, short on specifics. Thus go most visits of U.S. Presidents to China, and **Barack Obama's** first trip proved no exception. Even as Obama and Chinese **President Hu Jintao** on Nov. 17 offered a lengthy Joint Statement pledging cooperation on climate change, clean energy, and more military-to-military exchanges, little headway was made on the all-too-real economic and trade stresses plaguing the two nations. An increasingly assertive China, aiming to preserve its export juggernaut to the U.S., frequently berates Washington for what it calls protectionism, citing sanctions this year against Chinese-made car tires and steel pipes. Beijing officials also fret publicly about the tanking dollar and the Fed's rock-bottom interest rates, which allow investors to borrow cheaply and fuel asset bubbles in Asia. Meanwhile, Obama's calls for faster appreciation of the Chinese yuan are likely to bounce off a Great Wall of silence.

| BW | **PAGE 022 "Is the Fed Creating Bubbles?"**





Shopping in New York: Retail sales rose smartly

CONSUMERS DO THEIR BIT

Economic tea leaves are often tough to read, but this week's batch seem mostly to spell "recovery." U.S. retail sales made a surprising leap, rising 1.4% in October (though just 0.2% excluding autos). Not counting cars, consumers over the past three months have been spending at the snappiest pace since before the crisis. U.S. inflation remains docile, with both wholesale and consumer prices up by 0.3% in October. The 16-nation euro zone seems to be mending, as GDP grew at a 1.5% annual rate in the third quarter. And take a gander at Japan, where GDP jumped at a 4.8% rate—the highest since early 2007. But then there's housing, where the big trouble began. While economists predicted an uptick, U.S. housing starts tumbled 10.6% in October, and permits dropped 4%, to an annual rate of 552,000. That didn't discourage investors, who by Nov. 18 had pushed the S&P 500's gain this year to 23%.

10.6%

Drop in U.S. housing starts in October, the biggest monthly decline since January.

Data: Commerce Dept.

CLOUDY CLIMATE SUMMIT

It's not going to happen in Copenhagen. On Nov. 15, **President Obama** conceded there isn't time for the world to work out a legally binding deal to slash climate-altering emissions at

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Obama and Hu in Beijing: Pledges of cooperation but few concrete agreements

December's climate summit. Instead he is backing a Danish plan to move the scrum of squabbling nations towards a political commitment to tackle global warming, with the legal details to be hashed out later. One key reason for the delay: While climate policy in Washington has changed drastically since Obama succeeded **President George W. Bush,** Congress hasn't yet passed legislation requiring emission cuts at home. Besides that, divisions remain wide between developed and developing countries—and even among the wealthy nations themselves.

(TOP) JASON REED/REUTERS; (LEFT) DANIEL ACKER/BLOOMBERG

FINANCE

TAXPAYERS COME CLEAN

Suddenly the urge to confess seems to have smitten certain American citizens. On Nov. 17 the **IRS** said more than 14,700 tax evaders who held funds in offshore bank accounts have submitted mea culpas in recent months, paying back taxes and penalties. Needless to say, this wasn't a mysterious crisis of conscience. Rather, the culprits feared painful fines and potential jail time should they have been caught. And the chances of getting nabbed shot up in August when Swiss bank **UBS,** having admitted criminal wrongdoing in helping clients dodge taxes, agreed to fork over the names of 4,500 people. When worried clients heard that, they came forward in droves.

ONE MESSY BAILOUT

Neil Barofsky pulled no punches in his Nov. 17 report about the bailout of **AIG,** and those emerging with a black eye include every major Wall Street bank and the current **Treasury Secretary.** Barofsky, **Special Inspector General for the Trouble Asset Relief Program,** focused on the second phase of the rescue of the floundering insurer: the nearly $30 billion payment to institutions that had entered into credit-default swaps with AIG. The report says the bailout by the **New York Fed,** which was then led by **Timothy Geithner,** was poorly handled from the start. First, when a private-sector bailout plan fell through, the Fed had no backup position and quickly

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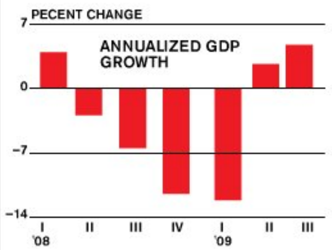
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SIGNS OF LIFE IN JAPAN



Data: Bloomberg

lent AIG $85 billion on terms that proved unsustainable. Next the Fed botched negotiations over the $30 billion payout by treating the counterparties—such companies as **Deutsche Bank, Goldman Sachs,** and **Merrill Lynch**—with kid gloves and bending over backwards to keep their identities secret. Barofsky also lays out in painful detail the unwillingness of any counterparty except UBS to accept one penny less than top dollar.

STRATEGY

TRUMP STILL HOLDS CARDS

The Donald is back at the table—sort of. After seeing his New Jersey casino empire slide into bankruptcy for the third time, real estate baron **Donald Trump** on Nov. 17 folded his bid to regain control but didn't give up his seat. As part of a deal with bondholders, Trump will get a 10% stake in a recapitalized **Trump Entertainment Resorts,** which owns three **Atlantic City** casinos. In exchange, Trump and his daughter **Ivanka** agreed to drop claims against the company. Trump will be free to use his name on other gambling ventures but not in five neighboring states. He and Ivanka quit the board in February.

GM PICKS UP SPEED

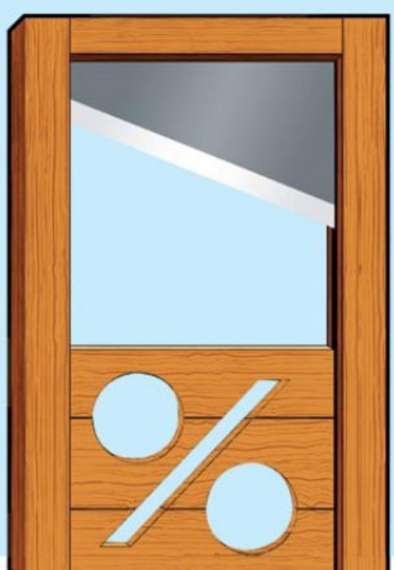
Sure, it's not cruising at 70 mph, but at least this looks like forward motion. On Nov. 17, **General Motors'** first finan-



GM's Fritz Henderson: The carmaker is starting to pay back the feds

IDEAS IS IT TIME TO DO AWAY WITH AMERICA'S 'DEBT BIAS'?

Imagine if your spouse lectured you on the evils of junk food but then offered to subsidize your Twinkie habit. Well, that's pretty much how it is with Americans and the government, argues the *New Yorker*'s financial columnist, **James Surowiecki,** in the Nov. 23 issue. The U.S. tax code allows individuals to claim deductions on mortgage interest, up to $1 million, while corporations can write off all the interest on their debt. As a result, the economy suffers from what dismal scientists call a "debt bias." The tax break encourages homebuyers to make smaller downpayments and take out bigger mortgages. It also inflates housing prices, studies have shown. Similarly, the break makes it up to 42% cheaper for companies to take out debt than to issue equity, estimates the **National Economic Council.** While the tax system alone can't be blamed for the current slump, a recent **IMF** study found that tax distortions likely led American households and companies to take on much more debt than they would have otherwise.



Surowiecki suggests the crisis should prompt Washington to rewrite the tax code. That won't be easy: In 2005 a Presidential panel on tax reform proposed doing away with the business-interest deduction and ratcheting down mortgage-interest tax breaks—but Congress studiously ignored the suggestions. Other countries, however, have shown it can be done. Britain scrapped its mortgage tax break in 2000, while Germany and Denmark last year pared back deductions on business-loan interest.

▸ *The New Yorker*, "The Debt Economy"

ROY RITCHIE/WONDERFUL MACHINE; CHART BY RAY VELLA; ILLUSTRATION BY THOMAS FUCHS

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010 EXECUTIVE SUMMARY



A Suntech plant in China: The company will soon build one near Phoenix

QILAI SHEN/BLOOMBERG

cial results since motoring out of bankruptcy in July showed a $1.2 billion loss in the third quarter. Take away restructuring charges, and the losses come close to $700 million—still red ink, but way shy of the $4.2 billion lost in the same quarter a year ago. GM says it will make a $1 billion payment on a $6.7 billion federal loan in December and pay the Canadian government $200 million. Meanwhile, GM's former lending arm, **GMAC Financial Services,** dismissed **CEO Alvaro de Molina** and replaced him with a board member, former **Citigroup** executive **Michael Carpenter.** GMAC, in which GM holds a stake capped at 10%, has twice been bailed out by the **Treasury** but so far has failed to repair its battered mortgage business.

A TRIP'S GREEN OFFSHOOTS

President Obama's visit to Beijing nurtured green tendrils twining between the two largest emitters of greenhouse gases. China's **Suntech Power,** the world's top maker of conventional solar panels, unveiled plans on Nov. 16 to open a factory near Phoenix in 2010. Likewise, Shenyang-based **A-Power Energy Generation Systems** said it will build a new turbine plant in the U.S. after it was chastised for aiming to use China-made windmills on a proposed Texas wind farm. Meanwhile, **Peabody Energy,** the No. 1 U.S. coal producer, said it will hook up with China's biggest utility, **China Huaneng Group,** to co-develop a power plant in Tianjin designed to capture and store CO_2 waste gas.

"China Solar Panel Maker Sets First U.S. Plant" businessweek.com/magazine

THE *BUSINESSWEEK*/ YOUGOV OPTIMISM METER

SUNNIER SKIES AHEAD?



The Optimism Meter, a proprietary measure of sentiment and expectations, economic statistics, and market forecasts, clocked in at 46 on Nov. 17, up from 25 on Nov. 2. Developed to evaluate shifts in outlook among individuals, professional investors, and economists, the meter gauges optimism about jobs, the stock market, and growth. Stronger GDP and surging stocks have caused the mercury to rise.

*Calculated using consumer polling, economic forecasts, and financial markets data; 0=lowest and 100=highest
Data: YouGov, Bloomberg, *BusinessWeek*

LEADERSHIP

A BOSS FOR LAZARD

Rocked by the unexpected death in October of legendary dealmaker **Bruce Wasserstein,** investment bank **Lazard** has chosen to go with a trusted if less celebrated insider. On Nov. 17 the board named **Kenneth Jacobs,** 51, as CEO. Jacobs, a 22-year veteran and currently head of North American operations, was selected over other internal candidates who had been viewed as more likely picks. Under his tenure, the North American unit has beefed up its presence in midsize deals and opened offices in Boston and Washington.

BW'S NEW EDITOR

Josh Tyrangiel, a top editor at *Time*, will soon become the editor of a **Bloomberg**-owned *BusinessWeek*. The acquisition of the magazine by the financial data and news giant is expected to close on Dec. 1. Tyrangiel, 37, has been serving as deputy editor at *Time* and chief of its Web operations. Tyrangiel says his goal will be to create "an indispensable business weekly." Previously, he worked as a writer for *Rolling Stone* and *Vibe* and as a producer at **MTV.** He succeeds **Stephen Adler,** who's resigning when the deal closes.

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FACETIME | MARIA BARTIROMO





(TOP) BRAD TRENT; JENNIFER S. ALTMAN

STEVE SCHWARZMAN STARTS WARMING UP

At the height of the private equity boom, no firm was flying higher than Blackstone Group, the juggernaut founded by Pete Peterson and Steve Schwarzman. In the past couple of years, Blackstone's profile has been considerably lower than it was in early 2007 when it paid $39 billion for Equity Office Properties in the biggest real estate buyout deal ever. Now, Blackstone is looking tanned, fit, and ready for action. On Nov. 6, Bloomberg reported that the publicly traded Blackstone posted a third-quarter profit of $275.3 million, and in a conference call, Schwarzman said the firm is planning eight or more initial public offerings of companies in its portfolio in coming months. Blackstone has also just launched a fund-management firm in China and (little fish, take note) is finalizing a $2.3 billion deal to buy Busch Entertainment, which owns theme parks like SeaWorld in Orlando.

MARIA BARTIROMO

You told investors in a conference call on Nov. 6: "We see the world changing once again, at least for private equity. The worst is behind the industry." What did you mean?

STEPHEN SCHWARZMAN

Obviously, the improvement in the economy makes an enormous difference. That's been exceeded by the

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improvement in the markets. We've had much lower interest rates, and equity markets around the world have recovered, which provides a lot of options for us in terms of exits. Institutional investors have been concerned about getting more money back from the private equity investments they made. So it looks like that's starting to flow. And we can see within our own portfolio the opportunity to have exits for our investors.

It seems as though many firms are trying to get out while the getting is good and take advantage of the recovering economy. You're planning to list up to eight companies and sell at least five others. Is that right?
That's the way it looks at the moment. You know, that can change up or down. But that type of alternative for us as managers in private equity really wouldn't have been there three to six months ago.

So what's the biggest change on Wall Street and the lessons learned over the past two years?
The changes on Wall Street are immense. There are major players who no longer exist, and the remaining players are making more money because there are fewer competitors and bigger spreads. And you're seeing a revolution in terms of the potential regulatory structure.

> "You actually have to put in pretty good-size equity checks to do reasonable deals"

When you look back at the boom years for private equity, were they good for the American economy or just good for private equity?
I think it's pretty clear those boom years led to excess. Leave aside private equity for the moment. When you look at the impact of rating agencies on subprime loans and the ability to create leverage in the system generally, it's pretty clear that was way overdone. The American consumer over-borrowed. Real estate was over-leveraged. And to some degree, private equity was paying too much money for companies. And we had a regulatory regime that was set up in the 1930s and could not cope with modern types of securities.



Blackstone is buying Busch Entertainment, which owns SeaWorld

You know, I was looking at one of our interviews from a couple of years ago, right in the middle of the boom. I said to you: "How easy is it to do a deal today?" And you said: "Look, I could do a $30 billion, $40 billion deal in a very short period of time with no covenants." What kind of a deal can you do these days?
Well, fortunately, Maria, we didn't do many of those. And the world has changed quite dramatically. You know, you can do transactions in the $3 billion-to-$5 billion range. The amount of debt you can borrow is probably in the five-times-cash-flow range. That's down from as high as 11 at the peak. And the equity in the capital structure, which got as low as 10% at the top of the cycle, could be in the 30%-to-45% range now. You actually have to put in pretty good-size equity checks to do reasonable deals. But deals of a few billion dollars that require $500 million of equity or deals at $3 billion to $5 billion that require a billion dollars of equity—that's still quite a big equity check in the old world or the new.

So would you put money into some of these depressed areas, whether it's retail or the consumer-related areas or financial services?
I think you have to be selective. We're buying the Busch amusement parks. And we're buying at what we believe is a very good price.

Are you interested in resources? We're seeing so much money move into commodities.
Resources are interesting, but you have to be really careful. There's been a huge cyclical rebound in resources—and not necessarily because those commodities are being utilized in what is a slowly growing global economy. Those resources are going up because the world is getting a little unsure about paper money. And different types of resources—gold, hard resources to some degree, oil—are used as offsets for currencies that are subject to the fiscal deficits of governments around the world. So, we like resources, but we're a little cautious given how much commodities have run up. | BW |

Maria Bartiromo is the anchor of CNBC's Closing Bell and writes the blog, Maria Bartiromo's Investor Agenda, at investoragenda.cnbc.com

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A LIFELINE OF CREDIT FOR THE RECOVERY

Lending remains tight, but overall bank standards are relaxing, and that will make it possible for businesses to expand as demand picks up

Credit conditions have always played a big role in the business cycle, but never to the extent they have over the past year or so. That's why the patterns in borrowing and lending, especially among businesses, deserve special attention now. Credit is essential to replenishing inventories, purchasing new equipment, and expanding payrolls, all of which will be needed for a self-sustaining recovery.

While the drag on the economy from tight credit has eased enormously, the borrowing climate is still not normal. Banks continue to tighten their lending standards, and loan demand remains weak. In the financial markets, much of the improvement is the result of ongoing programs by the Federal Reserve to keep credit flowing. However, these funds tend to help only large corporations. Small businesses, which lack access to Wall Street capital, must deal with stingy banks.

The remaining tightness is sure to limit the strength of the recovery, but it will not prevent a lasting upturn. The Fed's fourth-quarter survey of lending practices shows only 14% of banks tightened their terms and conditions on business loans last quarter, down sharply from last year's record 83.6%. The level is about where it was two quarters into each of the last two recoveries. Less pervasive tightening is also evident for high-quality conventional mortgages and consumer loans (chart).

Since the Fed's lending survey began in 1990, the net percentage of banks tightening their standards on corporate lending has been a good leading indicator of the economy's momentum a quarter or two ahead. This measure correlates well with the quarterly patterns of equipment spending, inventories, and payrolls, as well as overall growth. Based on that relationship, the current 14% reading suggests a continued pickup in growth through the first half of next year, and the Fed's next survey will likely show even less stringent lending standards.

10%

Share of small business owners in October who said not all their credit needs were being met

Data: NFIB

Keep in mind that only about a fourth of all lending to nonfinancial corporations is from banks. While loans from banks and other lenders have fallen by $57 billion over the year through the second quarter, overall borrowing has risen, lifted by a $314 billion surge in the issuance of corporate bonds. Borrowing costs for Moody's Aaa-rated debt, and somewhat risky but investment-grade Baa-rated debt, are about where they were three years ago. Plus, their spreads compared with yields on Treasury notes have narrowed greatly, indicating investors' increased willingness to assume risk. Even issuance of very risky high-yield debt has accelerated sharply.

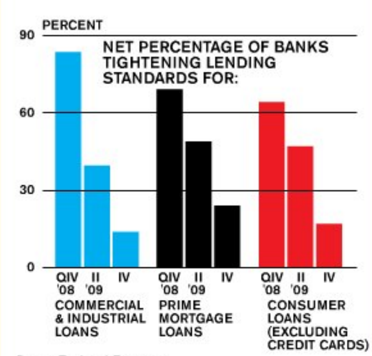
Equally important to the recovery, the corporate sector is in the unique position of not having to borrow at all to finance expansion. In the second quarter, corporate cash flow exceeded all current spending on equipment and construction by $156 billion. That windfall, unprecedented coming out of a recession, most likely ballooned further in the third quarter, as profits surged and capital spending shrank.

Getting credit flowing to small businesses will be critical to the recovery, given that the sector accounts for about half of all payrolls. The good news is that the Fed's survey also shows considerably less stringent terms and conditions on loans to small companies, with 16.1% of banks tightening standards this quarter, compared with 74.5% a year ago.

Many small businesses may say credit is harder to get, but National Federation of Independent Business Chief Economist William Dunkelberg says that's to be expected compared with the easy-money days before the recession. In fact, the October NFIB survey shows only 4% of companies say "financing" is their most important problem, compared with as high as 37% in the early 1980s. Dunkelberg says sales are the biggest concern right now.

On that front, demand is improving. The surprisingly broad 1.4% jump in October retail sales suggests consumer spending will contribute to economic growth for the second quarter in a row. As demand picks up, so will the need to borrow, and current trends imply there will be enough credit to keep the the recovery on track. |BW|

MORE BANKS ARE BECOMING LESS PICKY ABOUT LENDING



Data: Federal Reserve

BRAD TRENT; CHART BY RAY VELLA/BW

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NUMBERS

U.S. TRAVEL AND TOURISM ARE GOING NOWHERE

by Tara Kalwarski/Charts by Laurel Daunis-Allen

The downturn has pummeled U.S. tourism, with airlines and hotels suffering the greatest damage. Despite the dollar's decline against most other world currencies, fewer travelers are visiting. Sales at publicly traded travel companies in the U.S. are way down, while those in China have seen gains.

Happier Trails: Travel companies in China are outperforming those in the U.S.

ONE-YEAR PERCENTAGE CHANGE IN REVENUE AT THE WORLD'S LARGEST HOTELS, RESORTS, AND CRUISE LINES*

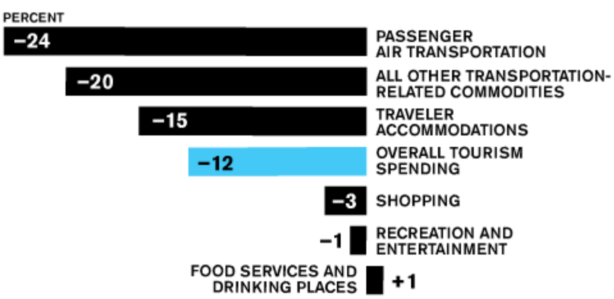
COMPANY	COUNTRY	CHANGE
Carnival	U.S.	-14%
China CYTS Tours Holding	China	29%
Gaylord Entertainment	U.S.	-12%
Marriott International	U.S.	-17%
Orient-Express Hotels	Bermuda	-17%
Royal Caribbean International	U.S.	-15%
Shanghai Jinjiang International Hotels Development	China	6%
Shanghai Oriental Pearl	China	2%
Starwood Hotels & Resorts Worldwide	U.S.	-21%
Wyndham Worldwide	U.S.	-17%

*Among those that have reported third-quarter earnings for calendar year 2009, as of Nov. 12

Data: Capital IQ

Planes, Trains, Etc.: Transportation-related expenditures have fallen furthest in the past year.

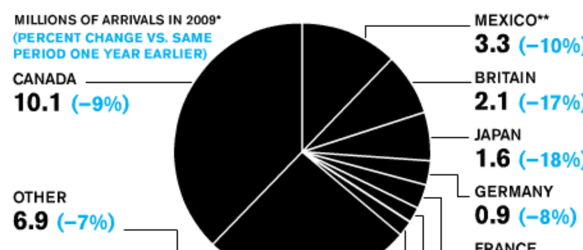
ONE-YEAR CHANGE IN TRAVEL SPENDING IN THE U.S. BY CATEGORY*



*Seasonally adjusted at annual rates as of Q2 2009
Data: U.S. Bureau of Economic Analysis

Declining Visits: So far in 2009, 10% fewer international visitors have arrived in the U.S.

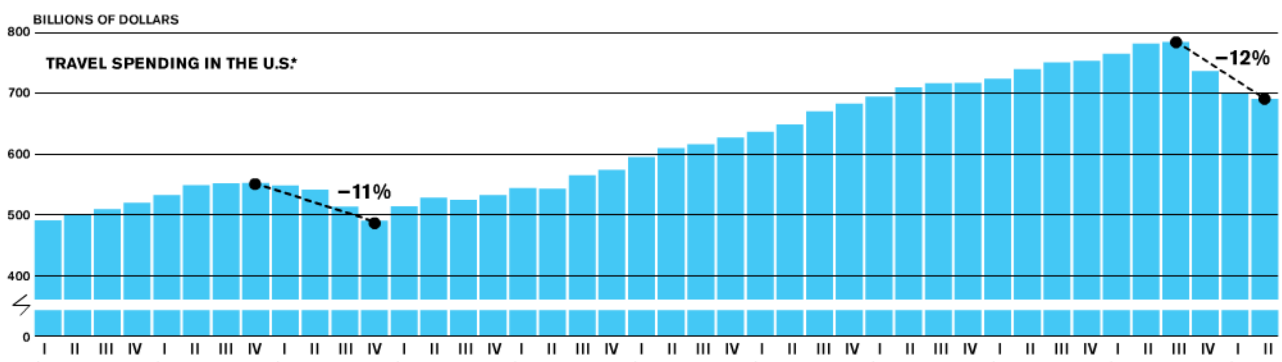
TOP COUNTRIES GENERATING TRAVEL TO THE U.S.



*Through July
**Excludes visitors who stay within the border zone
Data: U.S. Office of Travel & Tourism Industries

THEY'RE STAYING HOME IN DROVES

Travel spending in the U.S. has fallen by 12% since peaking in 2008. That's already a deeper drop than the last recession's 11% peak-to-trough decline.



Data: U.S. Bureau of Economic Analysis

*Seasonally adjusted at annual rates; excludes commuting and short, routine trips

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ILLUSTRATION BY KOREN SHADMI

IT'S NOT A JUNKET, IT'S AN INVESTMENT

The bad press surrounding AIG's infamous October 2008 sales meeting in Dana Point, Calif.—where employees partied at a lavish resort as AIG got billions in a bailout—helped put a chill on the luxury hotel business. Companies ran scared, canceling meetings or switching them to less opulent venues. Maritz Travel, a meetings company, says between October and December of last year it had \$150 million in cancellations for 2009 bookings, a big chunk of its typical \$600 million in bookings annually. Spending on U.S. events this year will fall almost 13%, says the U.S. Travel Assn.

Now luxury hotels are trying to rejuvenate junkets—by couching them as wise investments. In September the travel association gave industry salespeople a 50-page study projecting bottom-line benefits for business events and travel. Ritz-Carlton, Hyatt, and Omni have chimed in with ad campaigns. The message: Hotel meetings, with their ballroom dinners, poolside cocktails, and afternoon golf outings, aren't frippery. They're a prudent way to motivate staff and cultivate new business. "It's not extravagant if it produces results," reads a Ritz-Carlton ad appearing recently in *The Wall Street Journal*. "It's not a bachelor party. This is my sales team," reads the headline of another ad popping up in business publications, this one from the Las Vegas Convention & Visitors Authority. Over the past 12 months, meanwhile, the Four Seasons chain has held roughly 130 events for prospective clients, in part to argue that a Four Seasons vacation is an effective employee incentive.

Meeting planners don't expect an immediate rebound. "There remains an air of caution and conservatism," says Josh McCall, CEO of Jack Morton Worldwide. But they say there has been renewed interest from clients. In October the San Francisco Fed held its Asia Economic Policy Conference at the Bacara Resort & Spa near Santa Barbara, Calif. (Attendees paid their own way.) Evidently, even federal regulators can recognize the benefits of fun in the sun. *—Burt Helm*

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ASIA'S MBA HOPEFULS LOOK HOMEWARD

The U.S. is still the most popular destination for business school applicants from Asia, who now make up 29% of all GMAT takers. But more of the region's MBA hopefuls are looking closer to home when picking a program. A study from the Graduate Management Admission Council, which administers the GMAT, shows those taking the test in Asia forwarded a lower percentage of their score reports to U.S. schools in 2008 (71%) than they did in 2004 (77%). The number sent to Indian MBA programs was up 470%. B-schools in Singapore received 305% more, and 112% more scores went to programs in China. One reason for the tilt away from American MBA programs: the move by U.S. lawmakers to restrict the hiring of foreigners on H-1B visas. (Most Asians who study in the U.S. hope to stay.) A second reason, says GMAC President and CEO David Wilson, is that Asian B-schools "are stepping up their game in terms of curriculum, students, and faculty." *–Frederik Balfour in Hong Kong*

ILLUSTRATION BY KOREN SHADMI; PHOTOGRAPH BY SUMMIT ENTERTAINMENT

WHY HOLLYWOOD LOVES TO REPEAT ITSELF

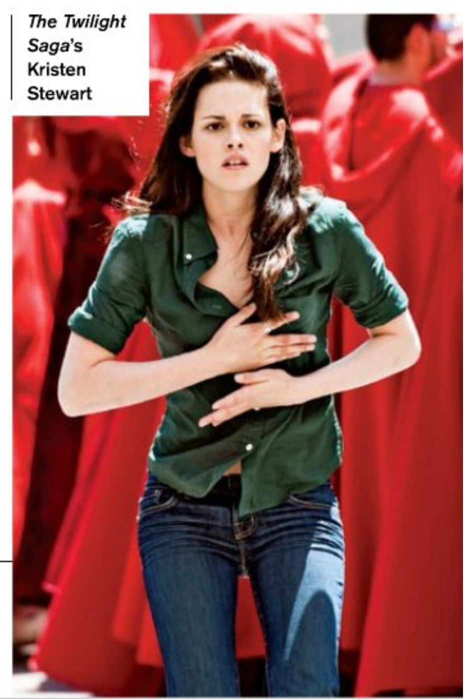
With their built-in fan base, sequels are seen as a safe bet in Hollywood. Now research by two academics—one at Cass Business School in London, the other at Texas Christian University's Neeley School of Business in Fort Worth—shows just how safe. The two studied the take for more than 100 movie sequels released from 1998 to 2006. Comparing those box-office numbers with what was earned by thematically similar standalone films shown around the same time, they found sequels generated an average 27% more revenue. Using their formula, they estimate the upcoming teen vampire film *The Twilight Saga: New Moon* (the second in the Twilight franchise) should make $34 million more domestically than an upcoming standalone movie about adolescent bloodsuckers. The professors, TCU's Mark Houston and Cass' Thorsten Hennig-Thurau, also studied the "feedback" effect of follow-up flicks, finding that they're responsible for boosting DVD sales of their parent films by 1.3 million copies.
–Mark Scott in London

$533

U.S. box office, in millions, for Batman follow-up *The Dark Knight*

Data: boxofficemojo.com

The Twilight Saga's Kristen Stewart



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032 Hackers go after Adobe



IS THE FED CREATING NEW BUBBLES?

Its easy-money policy has Asia worried. But Bernanke says fears of a speculative surge are overblown

By Peter Coy

America's super-easy monetary policy has drawn a blast of criticism lately from the high and mighty of Asian finance. President Barack Obama and Federal Reserve Chairman Ben S. Bernanke stand accused of blithely ignoring the risk of new asset bubbles and more economic mayhem.

As critics see it, the Fed helped inflate the tech and housing markets over the past decade and is setting up the global economy for another doozy with its near-zero short-term interest rates. Global investors can borrow dollars cheaply and invest the borrowed funds in assets ranging from Indonesian stocks to copper futures contracts, a strategy known as a carry trade. During Obama's recent Asian swing, China Banking Regulatory Commission Chairman Liu Mingkang warned that U.S. monetary policy is creating "new, real, and insurmountable risks to the recovery of the global economy, especially emerging-market economies." Bank of Japan Governor Masaaki Shirakawa and Hong Kong Chief Executive Donald Tsang issued similar warnings.

But there are two sides to this story. In detailed speeches and impromptu remarks, Bernanke and other top Fed officials have been making an interesting case that there's less to the much feared bubbles than meets the eye. First, they say few if any asset classes are obviously overvalued. Second, they say that trying to prick bubbles by raising interest rates could kill the nascent economic recovery. And third, they argue that the better way to cope with overheated markets is to strengthen financial institutions so they can withstand the inevitable bust—something Bernanke & Co. admit they've failed to do in the past. On Nov. 16, Bernanke and Vice-Chairman Donald L. Kohn made it clear in separate appearances that asset markets are not the focus of Fed monetary policy. The next day in Hong Kong, Federal Reserve Bank of San Francisco President Janet L. Yellen said, according to her prepared remarks, that it's "far from clear" that the Fed should "seek to lean against potentially dangerous swings in asset prices."

Rather than raise rates to avoid bubbles, Bernanke argues, the Fed must strengthen banks to withstand the inevitable pop

The Fed's seeming nonchalance about excesses isn't going over too well in U.S. financial circles. New York University economist Nouriel Roubini argues that the Fed is inviting speculative excesses in all kinds of risky assets by providing cheap dollar financing for what he calls "the mother of all carry trades." Massachusetts Institute of Technology economist Simon Johnson faults Bernanke's predecessor, Alan Greenspan, for ignoring the risk of bubbles and says, "The intellectual apparatus of Greenspan is still there." Adds Richard Bernstein, CEO of Richard Bernstein Capital Management: "[Bernanke] and Greenspan said that identifying bubbles was difficult, but that cleaning up after them was manageable. That has clearly been shown to be untrue."

Actually, Bernanke isn't saying that it's impossible to outsmart the market and spot a bubble in the making—only that "it's extraordinarily difficult." Right now, he told an audience of 1,800 at a Nov. 16 Economic Club of New York luncheon, "it's not obvious to

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ILLUSTRATION BY DANIEL ADEL

me that there's any large misalignments in the U.S. financial system."

The Fed chief has a point. Even though U.S. stocks have risen more than 60% since March, prices are within their historical range in relation to projected earnings for the coming year. Oil has more than doubled, to $80 a barrel from $34 in February, but that seems like a reasonable level with the bounceback in global demand. Treasury bonds don't seem overpriced given today's subdued inflation, and junk bonds are fetching normal premiums over Treasuries. Even emerging-market stocks and bonds, which many consider to be overpriced, are well within their historical ranges for value, says John Higgins, senior international economist for Capital Economics, a London consulting firm. Yes, gold at more than $1,000 an ounce does reflect fear among some investors about a resurgence of inflation, but the inflation expectations of the bond market and the public remain contained.

Roubini's "mother of all carry trades" is not much in evidence, either. If lots of investors were borrowing dollars to invest in other assets, there would be an obvious spike in dollar loans. Instead, U.S. bank lending remains way off its peaks. Securitized lending in dollars by Wall Street firms is also down.

U.S. FIRST

Complaints from China and Hong Kong about the Fed's low rates are even easier to dismiss. If they allowed their currencies to appreciate vs. the dollar, as the U.S. has urged, the threat of asset bubbles would quickly recede. The Fed has to set rates for the good of the U.S. economy, which is clearly still in need of cheap money. On Nov. 18 the Commerce Dept. reported an 11% drop in October in the annual rate of starts on housing construction. The unemployment rate of 10.2%, nearing a postwar high, is weighing on all sectors of the economy.

Still, what if bubbles do start to form? The Fed says it will deal with them only to the degree that they affect its "dual mandate" from Congress—to keep overall prices stable and attain full employment. Jacking interest rates up and down in an effort to tame the stock market or other asset prices could cause bigger swings in prices and employment, Kohn said in a Nov. 16 speech at Northwestern University's Kellogg School of Management.

Instead of using interest rates to deflate bubbles, the Fed intends to employ what it calls "macroprudential regulation." That means regulating banks with an eye on markets, not just the bank's balance sheet. For example, a lending strategy that might look safe for any single bank is dangerous when

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lots of banks follow the strategy and all try to get out at once. One idea being pushed by the Fed and the Obama Administration is to require banks to tighten underwriting standards in good times, and build up thick capital buffers that could be used in bad times. "It's akin to caring for an entire ecosystem rather than individual trees," says Yellen.

The Fed's critics continue to worry that keeping interest rates near zero is the monetary equivalent of pouring gasoline on a fire. Paolo Pellegrini, who helped prick the housing bubble as a bearish hedge fund manager at Paulson & Co., says that trying to discipline markets through banking regulation while at the same time plying them with cheap money is "like having a very strongly worded law that says 'don't murder' and then going out and handing people lots of guns."

The debate over how to deal with asset bubbles isn't going away. It's "perhaps the most difficult problem in monetary policy of the decade," Bernanke acknowledged at the Economic Club luncheon. For now, count on the Federal Reserve to keep interest rates extremely low until the recovery is well established—no matter what's happening in asset markets. | BW |

–With David Henry and Peter Carbonara in New York and Dexter Roberts in Beijing

Business Exchange

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Mother of All Busts?
Nouriel Roubini painted a frightening picture in a *Financial Times* op-ed on Nov. 2. The New York University economist said investors had made big returns by borrowing in dollars and investing in countries with higher-yielding assets and rising currencies. He predicted "the biggest coordinated asset bust ever" when the dollar stops falling and investors rush to sell their foreign holdings and get back into dollars.

To read the article, go to **http://bx.businessweek.com/global-economy/reference**

A CHILL IN BRITAIN

With more layoffs looming, it may struggle in 2010, too

By Stanley Reed



LONDON Don't tell Alex Ciangola that Britain's recession may soon be over. Sure, stocks are soaring and home prices are ticking up, but that's not translating into a rebound at Eclipse Hairdressing, Ciangola's chain of four tony salons. His customers are spending about 25% less on haircuts and color, and he has been forced to let his staff shrink by about the same amount, to 27 people today. "It's been a very difficult year," he says.



The City, London's financial district, is one place where hiring has turned up

KIERAN DOHERTY/REUTERS

Until recently, Britain's was the star of Europe's big economies. It grew at an annual average of 2.5% from 2000 to 2008, eclipsing Germany's 1.5% annual pace and France's 1.9%. But while the Continental powers emerged from recession in the second quarter, the British economy continued to contract, shrinking by 0.4% in the third quarter. For the year, Britain's gross domestic product is expected to fall 4.7%, and pessimists say its high debt levels and dependence on financial services mean it will struggle in 2010. Crippled banks are unable to extend much credit, and household debt stands at more than 150% of income, so consumers will be reluctant to spend.

While big companies can still borrow in the bond market, small businesses—the chief job creators in good times—can't get financing. Weather Front, an online retailer of weather instruments in the coastal town of Eastbourne, had wanted to improve its Web site to prepare for an economic rebound. But owner Alistair Barron couldn't get a loan to pay for the upgrade and has since laid off two of his 10 employees. "By next summer we would have had a much bigger offering," Barron laments.

A surprisingly rigid labor market is also keeping a lid on growth. As British companies have avoided mass layoffs, unemployment has climbed to just 7.8% from 5.8% a year ago. That's good for workers, but it means productivity has fallen, so some economists are predicting further job cuts, which would delay any recovery. "The British labor market has performed far more like its German counterpart than its American cousin," says Danny Gabay, director of Fathom Financial Consulting in London.

The news isn't all bad. The City of London, Britain's financial center, is starting to hire again. Money is also pouring into commercial real estate, pushing prime property values up by 5% to 10% in recent months, says David Atkins, CEO of Hammerson, which has an $8 billion portfolio of big buildings. Rents, though, have yet to catch up as retailers and other businesses, he says, "still face significant challenges."

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CISCO'S EXTREME AMBITIONS

CEO John Chambers is now chasing market share in 30 different categories—and making powerful enemies

By Peter Burrows

During Cisco Systems' annual meeting on Nov. 12, John T. Chambers, chairman and chief executive, strode confidently around the auditorium at Silicon Valley's Santa Clara Convention Center. But he faced a barrage of tough questions about the company and its prospects. At one point, looking a tad dazed by the onslaught, he sat down on the steps of the stage. "At what size does Cisco become so big and diverse that its growth and profitability will plateau?" one investor asked. Chambers considered the question for a few seconds. "Hopefully, well after the CEO retires," he said with a laugh.

It's no joke for investors. Chambers is struggling to show how his $36 billion behemoth can remain a growth company and improve its stock market performance. The challenge has the 60-year-old CEO trying to pull off one of the most ambitious feats in business. He's racing into 30 different markets at the same time, while implementing a council-based management approach that's controversial among top managers. Now Chambers' ambition is fueling a risky fight with some of the mightiest companies in tech, including Dell, Hewlett-Packard, and IBM. "It's a clash of the titans, and investors are nervous," says analyst Brent Bracelin of Pacific Crest Securities.

CHAMBERS' CHALLENGES

CEO John Chambers has ambitious plans for Cisco, but is he trying to do too much?

MARKETS

Cisco is trying to simultaneously expand into markets ranging from video cameras to servers. No company has tried to pull off such an expansion before.

MANAGEMENT

Chambers set up a series of councils to help make management decisions more quickly. Insiders complain of growing bureaucracy and a lack of clear authority.

COMPETITION

Cisco grew to dominate the networking market by trouncing smaller rivals. It's now on a collision course with Hewlett-Packard and IBM, larger and more powerful companies.

SETTING A TORRID PACE

Chambers may have more to lose than his rivals. As he moves into the computer server market led by HP, Chambers has provoked a counterattack on his core business of routers and switches, which direct traffic around the Internet. HP said on Nov. 12 it would buy networking equipment provider 3Com to step up its assault. The trouble for Chambers is that gross margins in the server business are around 20%, compared with 65% for routers. As Cisco gets more revenue from servers, its overall margins will likely fall, while HP will probably see margins rise as it sells networking gear. "I'd rather be HP than Cisco right now," says Steve Deplessie, founder of the research firm Enterprise Strategy Group.

Chambers declined to comment for this story, but he has explained his strategy publicly. He sees the challenging times in the tech industry as an opportunity for the strong to get stronger. He believes Cisco can keep growth high by charging into markets for everything from $149 Flip video cameras to multimillion-dollar data center projects. He established the new councils—48 in all—so managers can make decisions without waiting for approval from him or anyone else. He says the councils are the primary reason Cisco can pull off a greater variety of acquisitions than ever before. "We're going to set a pace, and we'll challenge anyone to keep up with us," Chambers said at the annual meeting.

Cisco is having some success in new markets. The company has become a leader in computer security and office phones. Where it can't beat the competition, it buys them. It's offering $3 billion for Tandberg, a Norwegian company that makes videoconferencing systems that have proven more popular than Cisco's high-end products. "They've done a good job so far," says David Eiswert, portfolio manager at T. Rowe Price's Global Technology Fund, which holds Cisco shares.

Chambers may have few options other than taking on tougher fights. He has pledged that Cisco will boost revenues 12% to 17% yearly, but investors are skeptical. Cisco's stock is off about 20% over the past two years while shares in IBM and HP are up. "I think he has no choice, if he really wants Cisco to be a growth company," says analyst Erik Suppiger of Signal Hill Capital. "But does it raise considerable execution risk? It sure does."

Chambers crossed the Rubicon in March, when Cisco announced a new server. It's part of a broader strategy to reinvent the data centers that companies increasingly use to handle their computing needs. Cisco hopes to charge premium prices for gear that will let companies more efficiently handle their Internet traffic.

Still, HP has years of experience competing with Dell at razor-thin margins, and it has more than 150,000

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ERIC MILLETTE

Despite Cisco's size, CEO Chambers says it will now be far more nimble

consultants who help sell its gear to corporate customers. "Cisco has to figure out not only how to beat us but also how to beat IBM and Dell, and compete at margins very different than what they're used to," says Dave Donatelli, executive vice-president at HP.

IBM and Dell have long sold Cisco's networking gear, butthere are increasing signs of strain in those relationships. Big Blue just inked a deal with rival Voltaire and is shipping gear from Juniper Networks, including to the New York Stock Exchange, a former Cisco customer. Dell recently inked a deal with Juniper to resell its gear. "If the enemy of your enemy is your friend, we have a lot of friends right now," says Kevin Johnson, chief executive at Juniper.

Chambers certainly knew the risks of taking on the computer giants. Earlier this decade, former Cisco executives Jayshree Ullal and Andreas Bechtolsheim came up with a prototype for a server, but Chambers wasn't ready to take the leap. The debate erupted again in 2007 after Cisco took a stake in a startup called Nuova, created by longtime Cisco engineering chief Mario Mazolla, which was developing a server. Several top executives, including Charlie Giancarlo, voiced opposition at the expansion, but Chambers decided to proceed. Even the chief information officer at one of Cisco's largest customers is skeptical about the move: "They should have [gone after the data center] without getting into the server business."

FOR THE HISTORY BOOKS?

Some people wonder if Chambers' strategy is being driven by ego as well as by Cisco's needs. Two former executives say Cisco's council-based approach, whatever its intended purpose, is an effective way for Chambers to consolidate power. Diluting authority by spreading it across committees may prevent any one person from gaining too much control. Sources also say that Cisco executives considered heirs apparent have rarely lasted at the company for long. "Being No.2 at Cisco has not been a long-term assignment," says one former mid-level executive.

A Cisco spokesman says any suggestion its strategy is a result of ego is mistaken. Chambers admits the council structure is unusual but argues it's the only way a company Cisco's size can move as fast as it needs to. He says the councils work and help identify talent throughout the company.

In a sense, Chambers is bidding for a place in the history books. He's trying to use the ambitious expansion and unconventional management strategy to demonstrate how a company the size of Cisco can remain fast-growing and nimble. If he succeeds, he may end up regarded as a business icon, along the lines of General Electric's Jack Welch. "Cisco is trying to rewrite the management books," says analyst Tal Liani of Merrill Lynch. "We don't know yet whether it will be successful or not."

Chambers certainly senses the urgency. "I realize that many of you think we've stretched too far, and you may very well be right," he told shareholders at the close of the company's annual meeting. "In many people's opinion, [30 markets] is too many. In my opinion, it's probably too few." | BW |

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The streets of Mumbai: Vodafone is India's No. 3 cell carrier

VODAFONE'S INDIAN DILEMMA

It's signing up plenty of new customers, but price wars are putting a serious crimp in the carrier's margins

By Mehul Srivastava and Mark Scott

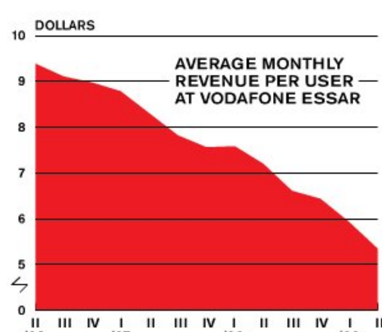
DELHI

Ruchira Sharma should be any mobile-phone company's dream. She has two cell-phone numbers and endless gossip to share with friends and family across the country. Problem is, she's in India, where calling rates are less than a penny a minute, by far the lowest in the world. So her carrier—Vodafone Essar, a unit of Britain's Vodafone Group—isn't making much from her gabbing. "It's fantastic," says the 19-year-old student. "I spent 330 rupees [about $7] in October, and I talk for hours."

Fantastic for her, but less so for a key Vodafone strategy. In May 2007 the company paid $11.2 billion for 67% of what would become Vodafone Essar. The Indian operation was the centerpiece of an ambitious expansion in emerging markets to make up for slowing sales in Europe. Vodafone, though, didn't factor in a price war that in October culminated in 50% cuts in rates and a switch to per-second billing (instead of one-minute increments—a big saving for people who make short calls). "Emerging markets can no longer offset problems at home," says Emeka Obiodu, an analyst at Ovum, a telecom advisory firm in London. "There's now too much competition for easy growth."

Vodafone's Indian unit has lost $64 million on some $10 billion in revenues since the purchase, and that was before the latest round of price cuts. Costs, meanwhile, will keep rising. Most new customers are in rural areas, where providing service is more expensive. And villagers use their phones sparingly, so Vodafone's average revenue per user in India has fallen to $5.30 per month from $8.79 two years ago.

CHEAP TALK



Data: Macquarie Capital Securities

To be sure, Vodafone, which owns 45% of Verizon Wireless, still has the biggest sales of any cell carrier worldwide. The company on Nov. 10 announced that first-half net profits had doubled, to $8.1 billion. But its emerging market operations have hit a rough patch. Vodafone expects its Qatar unit will lose $55 million this fiscal year, while its Turkish subsidiary lost $118 million in the six months ended in September. As a result of those setbacks and falling margins elsewhere, CEO Vittorio Colao doubled a cost-cutting target for the year ending next September, to $3.3 billion. While India remains promising, Colao told reporters in London, "the competitive intensity will remain until consolidation."

Another worry for Vodafone is a potential $2 billion tax hit. At issue is whether the purchase of the Indian unit, which had been held by a company registered in the Cayman Islands, is subject to Indian taxes. Vodafone declined to make any executives available for an interview, but a spokesman says the company is confident it will prevail.

India hasn't been a total disaster for Vodafone. The company is No. 3 in the market and is signing up some 2 million newcomers a month, about 90% of Vodafone's customer additions worldwide. With so much growth, getting less money from each user doesn't hurt as much as it might elsewhere, and Indian cell-phone companies can still eke out a profit before factoring in costs for expanding their networks. While expansion costs will likely climb next year as carriers introduce 3G networks, the superfast service "could be a big winner," says Katja Ruud, an analyst at Gartner Research. "In the short term, though, they need to find a way to buffer the costs of rural expansion." |BW|

GAUTAM SINGH/AP PHOTO

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HEALTH CARE: GE GETS RADICAL

It's offering only high-deductible, consumer-directed plans. That will save millions but may damage morale

By Jena McGregor

It's been a hard year to work at General Electric. Salary freezes have hit its famously performance-driven employees, with some managers taking pay cuts. The price of GE stock, which once made millionaires out of even hourly workers, has gone nowhere as the rest of the market has risen. A 68% dividend cut—the first in 71 years—has stung execs who rely on a heavy dose of restricted shares.

And now GE is making changes that could deal another blow to morale. The company is forcing its 75,000 salaried U.S. employees and 8,000 retirees under the age of 65 to choose what's known as a consumer-directed health plan, which includes deductibles that run as high as $4,000 a year. Traditional plans, where employees pay higher premiums in exchange for predictable co-pays up front, are no longer available for salaried workers. One employee says his colleagues "are looking at this as a cut in pay."

GE says the plan is being rolled out to make employees better health-care consumers and to coincide with its new "Healthymagination" strategy, a companywide initiative for health-care innovation. While GE says its future cost savings are unclear, people with knowledge of the situation estimate it could save $1 billion over the next decade or so. With three tiers of premiums and deductibles, GE spokesperson Sue Bishop notes, employees still have options. "It's not that different from their car insurance," she says. "You get to choose the amount of your premium, and that determines the amount of your deductible."



VARIABLE COSTS

The total cost of care will depend, of course, on the individual. Consumer-driven plans can save money for healthy workers who rarely visit a doctor or shop around. Typically, employees have lower premiums and save pretax dollars in health-savings accounts to pay much higher deductibles, with companies providing contributions to offset expenses. (GE will fund up to $1,000 for two of the three tiers.) While GE's plans offer free preventive care, for the first time, it's making smokers pay an extra $625 a year.

Workplace experts say that while many companies are adopting consumer-directed plans—about half now offer one, according to consultancy Watson Wyatt Worldwide—most offer them as part of a broader menu. Wharton School professor Peter Cappelli argues that this isn't the year to be piling big changes on an already battered employee base. "There's the death-by-a-thousand-cuts issue," he says. Veteran recruiter Peter Crist adds that the health-care change could add to the grousing he hears from GE executives. "At the high end, it's not just the money," says Crist. "It's the aggravation."

Indeed, there are indications that many are anxious about their new benefits, even if they can take comfort in knowing GE's salary freeze will lift in 2010. Some are overwhelmed by the complexity of the new plans. GE is offering Web tools, town halls, and coaches to help. But James N. Cawse, a former staff scientist at GE Global Research, says: "I'm a statistical analysis guy and I finally had to draw up a spreadsheet to make any sense of it." |BW|

—With Esmé Deprez

KEITH NEGLEY

NARROWER OPTIONS

GE's new medical plan for salaried U.S. employees may not elicit cheers

	THEN	NOW
Choice	Two types of programs—a preferred provider network and a traditional indemnity plan	One consumer-driven health plan with three tiers of costs
Charges	Spouses with access to insurance elsewhere pay up to $2,608	Same working-spouse fee; smokers pay an added $625
Costs*	Premiums from $363 to $1,627 per year and deductibles from zero to $600	Premiums from zero to $2,300 and deductibles from $800 to $1,600; GE funds $500 in two tiers

Data: GE; *BusinessWeek* *for individuals (more for families)

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CAN ADOBE BEAT BACK THE HACKERS?

As its software becomes a major means of attack, security experts wonder if it can fight hard enough

By Aaron Ricadela

For years, Adobe Systems has occupied a quiet corner of the personal-computer industry. Photographers and designers use its software to clean up photos and set up Web sites. Workers everywhere trade electronic documents formatted with Adobe's programs, often without knowing the company behind the software.

Now Adobe is attracting the unwanted attention of hackers—and security experts are concerned the company isn't doing enough to repel assaults. So far this year, Adobe has released nine security updates for the current version of its Acrobat Reader software, up from four in 2008, says Moscow security firm Kaspersky Lab. Adobe appears to have replaced Microsoft as the primary means by which hackers try to infect or take control of PCs. "Adobe at the moment is the main target," says Roel Schouwenberg, a Kasperky senior antivirus researcher in Woburn, Mass.

Historically, Adobe hasn't had to contend with attacks, so it hasn't been focused on potential weaknesses. But as Microsoft has toughened up its security, Adobe has become a more tempting prey. Its software, particularly Flash for Web video and Reader for documents, is loaded on virtually every personal computer.

Vulnerabilities in such widely used software can cause myriad problems. More than a dozen sites, including those of *The New York Times*, *USA Today*, and *Nature*, have been infected with fake ads that exploit Adobe software. In the case of the *Times*, if Web surfers clicked on an ad for antivirus software, malicious code would take control of their computers through Flash and direct them to a site infested with malware. Other attacks circulate via e-mail, with virus-laden PDF files that open in Acrobat Reader.

Adobe recently said it would release regular quarterly security fixes—but then missed its first deadline by a month

SCRAMBLING TO RESPOND

Security specialists fret Adobe lacks the firepower to stop the attacks. With an estimated $2.9 billion in sales this year, the company is one-twentieth the size of Microsoft, with a much smaller engineering staff. Microsoft issues monthly security patches for Windows and gives away antivirus software. Adobe said in May it would begin releasing regular quarterly security fixes for Reader in September and then missed that deadline by a month. A second update will be delayed until January. "So far there's been no consistency at all," says Chet Wisniewski, a security analyst at antivirus software maker Sophos.

Adobe concedes its popularity with hackers is growing but says it is gaining the upper hand. It has five times as many engineers working on security as two years ago and has trained its entire Reader team on safe programming practices. "We're over the hump of being reactive," says Chief Technology Officer Kevin M. Lynch. Adobe has sought security advice from Microsoft and Google.

If it gets a handle on its security problems, hackers will turn their attention elsewhere. Yahoo!'s instant messenger and Apple's iPhone, for example, are starting to see attacks.

The case of Adobe illustrates a conundrum for tech companies: They need to balance spending on new products, which brings in revenue, with spending on security, which doesn't. Adobe, though solidly profitable, laid off 680 people, 9% of its workforce, on Nov. 10. The need to step up security spending is "not an uncommon problem, but Adobe's going to have to get their arms around it," says Rob Enderle, president of consultant Enderle Group. BW



JACOB THOMAS

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WALL STREET



By Theo Francis, Ben Levisohn, Christopher Palmeri, and Jessica Silver-Greenberg

Photograph by Eric Smith

Taxpayers are taking another hit as strapped local governments fork over billions in fees on investments gone bad

Detroit Mayor Dave Bing is struggling to save his city from fiscal calamity. Unemployment is at a record 28% and rising, while home prices have plunged 39% since 2007. The 66-year-old Bing, a former NBA all-star with the Detroit Pistons who took office 10 months ago, faces a $300 million budget deficit—and few ways to make up the difference.

Against that bleak backdrop, Wall Street is squeezing one of America's weakest cities for every penny it can. A few years ago, Detroit struck a derivatives deal with UBS and other banks that allowed it to save more than $2 million a year in interest on $800 million worth of bonds. But the fine print carried a potentially devastating condition. If the city's credit rating dropped, the banks could opt out of the deal and demand a sizable breakup fee. That's precisely what happened in January: After years of fiscal trouble, Detroit saw its credit rating slashed to junk. Suddenly the sputtering Motor City was on the hook for a $400 million tab.

During late-night strategy sessions, Joseph L. Harris, Detroit's then-chief financial officer, scoured the budget for spare dollars, going so far as to cut expenditures on water and electricity. "I figured the [utility] wouldn't turn out

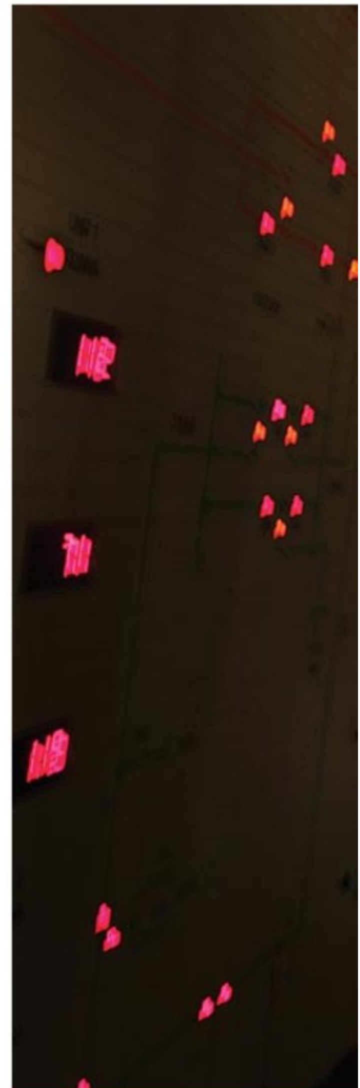
An abandoned school in Detroit. The city owes banks $4.2 million monthly

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THE MUNICIPAL SQUEEZE

States and cities owe Wall Street huge fees, which only exacerbate their financial woes

> Snyder calls a $120 million fee facing tiny Hoosier "a huge challenge"

our lights," says Harris. But there wasn't enough cash, and in June the city set up a payment plan with the banks.

Now Detroit must use the revenues from its three casinos—MGM Grand Detroit, Greektown Casino, and MotorCity Casino—to cover a $4.2 million monthly payment to the banks before a single cent can go to schools, transportation, and other critical services. "The economic crisis has forced us to move quickly and redefine what services a city can and should provide," says Bing. "While we face a tough road ahead, I believe we're on the right path." UBS declined to comment.

Detroit isn't suffering alone. Across the nation, local governments and related public entities, already reeling from the recession, face another fiscal crisis: billions of dollars in fees owed to UBS, Goldman Sachs, and other financial giants on investment deals gone wrong.

CHARM OFFENSIVE

The seeds of this looming disaster were sown during the credit boom, when Wall Street targeted cities big and small with risky financial products that promised to save them money or boost returns. Investment bankers sold exotic derivatives designed to help municipalities cut borrowing costs. Banks and insurance companies constructed complicated tax deals that allowed public utilities, transit authorities, and other nonprofit organizations to extract cash immediately from their long-term assets. Private equity firms, pointing to stellar historical gains, persuaded big public pension funds to plow billions of dollars into high-cost investments at the peak of the market. Many of the transactions shared a striking similarity: provisions that protected the banks from big losses and left the customers on the hook for huge payouts.

Now, as many of those deals sour, Wall Street is ramping up its efforts to collect from Main Street. "The banks stuffed customers with [questionable investments] and then extorted money from the customers to get rid of them," says Christopher Whalen, managing director at research firm Institutional Risk Analytics. The New Jersey Transportation Trust Fund Authority, for instance, must pay nearly $1 million a month at least until December 2011 to Goldman Sachs on derivatives deals tied to municipal debt—even though the state retired the debt last year. The Chicago Transit Authority (CTA), having entered into complex arrangements to lease its equipment to outside investors and then lease it back, could face termination fees of $30 million. The investors could collect penalties because American International Group, which backed the arrangement, has seen its credit rating tumble. "These [sorts of deals] are potentially huge liabilities," says Stanford Law School's Joseph Bankman. "Investors aren't going to be settling for chump change." Goldman Sachs declined to comment.

The financial struggles of America's cities and towns stand in stark contrast to Wall Street, where bonuses at some firms are expected to reach record levels in 2009, less than a year after the peak of the financial crisis. To keep public outrage from reaching a boiling point, banking chiefs are embarking on a charm offensive. Goldman CEO Lloyd Blankfein, who recently sparked controversy when he told a *Times of London* reporter that his firm was "doing God's work," pledged on Nov. 17 to invest $500 million in small businesses and charities. (That amounts to roughly 3% of the $16.7 billion Goldman expects to pay its employees this year.)

Politicians have launched their own campaign. Federal lawmakers, troubled by the rising payouts, are trying to limit the damage to municipalities and prevent them from falling prey in the future. Pending legislation in Congress, introduced by Representative John Lewis (D-Ga.) and Senator Robert Menendez (D-N.J.), would impose a 100% tax on termination payments like those in the CTA deals to dissuade banks from going after struggling municipalities. Another proposal would limit the use of derivatives by localities with less than $50 million in assets; lawmakers figure small towns and cities don't have the resources to vet the risks of exotic investments adequately.

Without a federal fix, strapped municipalities like Detroit could be forced to slash vital services even more. The city's public schools, which had been putting off paying textbook suppliers and other vendors, aren't likely to see their funding rise now that banks are taking a bite out of the city's budget. The Royal Oak school district is eliminating afterschool music programs and asking parents to pay $100 per child to play sports. "We've had to demolish programs because of the squeeze," says Thomas L. Moline, the district's superintendent.

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HAROLD LEE MILLER

Detroit's public transportation system is also feeling the pinch. Because of budget restraints, bus routes have been canceled and equipment hasn't been fixed. On a cold day in early November, a group of students stood shivering as they awaited the No. 30 bus. The bus comes only once an hour now, compared with every 45 minutes a year ago. Longtime driver Linda Martin, whose bus broke down five times in the past year, helped organize a demonstration in August. Months later, the 56-year-old grandmother of eight was among 113 transportation workers laid off. "These are hard-working people, juggling three jobs sometimes," she says. "If they lose their income, there's a ripple effect throughout the whole community."

Of course, many of the municipal-finance investments blowing up now were fairly standard contracts that clearly spelled out the pitfalls. "Municipalities knew the risks," says James S. Normile, a New York partner at law firm Winston Strawn. "They just didn't think they were going to happen."

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Former Detroit CFO Harris scoured the city budget for spare dollars

But some public entities, lacking the financial expertise, proved to be willing buyers for Wall Street's more dubious ideas. Consider the plight of Hoosier Energy Rural Electric Cooperative. In 2002 a group of attorneys and investment bankers presented the tiny non-profit utility, indirectly owned by its 800,000 mostly rural customers, with a quick way to earn some money. Hoosier Energy leased a power plant near the Wabash River in Sullivan County, Ind., to John Hancock Financial Services. Hancock then turned around and leased it back. As a result, the utility netted $20 million while Hancock planned to reap tax benefits on the facility. The bankers and lawyers, meanwhile, made $12 million. The transaction was part of a broader trend: Over the past decade dozens of utilities, transportation agencies, and other public nonprofit entities struck so-called leaseback deals to collect cash on their assets.

Around the same time the Hoosier agreement was finalized, the IRS began cracking down on leaseback deals. The federal agency in a memorandum called them a "sham" that lacked any business purpose beyond tax evasion and amounted to a circular exchange of assets and cash. Legally speaking, a transaction that merely reaps tax rewards and has no other economic purpose is often considered an abusive tax shelter. Although the IRS hasn't ruled on Hancock's tax breaks, U.S. District Court Judge David F. Hamilton concluded in an opinion last fall that they looked "abusive." Hancock says it believes it's entitled to the tax benefits.

VULNERABLE PUBLIC TRANSPORTATION

Now Hancock is exploiting a technicality in the 3,000-page pact with Hoosier that could allow the financial firm to wiggle out of the contract and collect a fat fee. Even though Hoosier has continued to make all of its payments, it fell into technical default after Ambac Financial Group, which backed the transaction, suffered a credit-rating downgrade. Having not found a suitable replacement, Hoosier faces a $120 million penalty, a sum that could exhaust its cash and credit lines. "It's a huge challenge for us," says Donna L. Snyder, Hoosier's vice-president for finance. "We're a small not-for-profit."

Hoosier may have to pay up soon. In September the Seventh Circuit Court of Appeals ruled the utility had to find a new guarantor this year or pay Hancock the money. If the latter happens, residents could face higher electricity rates. Already, Hoosier has hiked rates 3% because of the uncertainty of the deal. In the meantime the utility is conserving cash by postponing environmental upgrades to its coal plants and putting off payments to other power companies in the coop. Says Jonathan Chiel, John Hancock's general counsel: "We've acted reasonably, and we believe no party to the transaction should seek to gain an unfair advantage."

Public transportation systems around the nation could be vulnerable to leaseback blowups. Moody's Investors Service estimates that 25 big municipal transportation authorities entered into deals similar to Hoosier's. The fallout could be more than just financial. In recent years the Washington Metropolitan Area Transit Authority tied up a third of its subway fleet—almost 300 cars, some 30 years old—in a series of pacts with investors, some of which required keeping the same equipment running until 2014. To avoid violating the terms, the transit authority rejected a 2006 recommendation by the National Transportation Safety Board (NTSB) to replace or retrofit older cars. The NTSB warned at the time that in the event of a crash the old cars posed a higher risk of injury to passengers than newer models. One of the old cars was involved in a wreck in June that killed nine people. A spokeswoman for the transit authority said it lacks the funds to replace the cars.

Even public institutions that entered into relatively common investments are getting hurt. Many chased risky deals

MICHAEL NEMETH/WONDERFUL MACHINE

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Texas Retired Teachers' Lee: "Being novices, there's a certain level of trust"

MATTHEW MAHON

only in the later years of the credit boom and now are paying hefty fees on those underwater assets.

In 2006 the Teacher Retirement System of Texas hired T. Britton Harris IV to overhaul the $100 billion pension fund. The portfolio, one of the 20-largest pension funds, was still recovering from the dot-com bust earlier in the decade. Harris, a veteran of investment firm Bridgewater Associates and the Verizon Communications' employee pension plan, told board members: "My approach has never been incrementalist."

True to his word, Harris revamped the pension fund. For years, Texas Teachers had focused on stocks and bonds, relying on in-house managers to invest the money. The new investment officer proposed a huge shift into risky investments that promised better returns, including private equity and real estate. In April 2008—right after the fall of Bear Stearns—Wall Street chiefs flocked to Austin to seal their investment deals with the pension fund. Harris even hosted a dinner at a local steakhouse for Morgan Stanley's John Mack, Lehman Brothers' Richard Fuld, and Laurence Fink of BlackRock. "Being novices, there's a certain level of trust with decisionmakers," says Tim Lee, executive director of the Texas Retired Teachers Assn. The pension fund's target stake in alternatives swelled to 29%, from 8%.

Then the crash came. Texas Teachers recently reported that its new private equity and real estate investments had dropped by 15% and 33%, respectively, in the first nine months of the year. Among the clunkers: Colony Capital VIII, a fund that invested in the buyout of Station Casinos, a Las Vegas casino operator that later went belly-up, and Neverland Ranch, the estate of the late Michael Jackson. It likely will take awhile for the portfolio of alternative investments to recover.

Wall Street, though, will keep collecting its share. Private equity firms and hedge funds typically charge a hefty 1% to 2% fee on the total pool of assets under management even if their strategy loses money. On Texas Teacher's $13.5 billion portfolio, that amount to tens of millions a year. The fund says it remains committed to alternative investments. "We are long term and very liquid," says Harris. "This should be a time when the investments we make should prove rewarding."

Many of the million-plus educators who rely on the pension fund for their retirement benefits are worried about their financial fate. The fund's obligations exceeded its assets by $22 billion this year. To make up the difference, the fund's board asked Texas legislators this summer to increase contributions both from taxpayers and active teachers, but lawmakers rejected the proposal. That means retired teachers, who haven't seen a cost-of-living increase since 2001, aren't likely to get a bump anytime soon. Says Bill Barnes, a retired school principal from Fort Worth: "The whole question is: Where's the money going to come from?" **|BW|**

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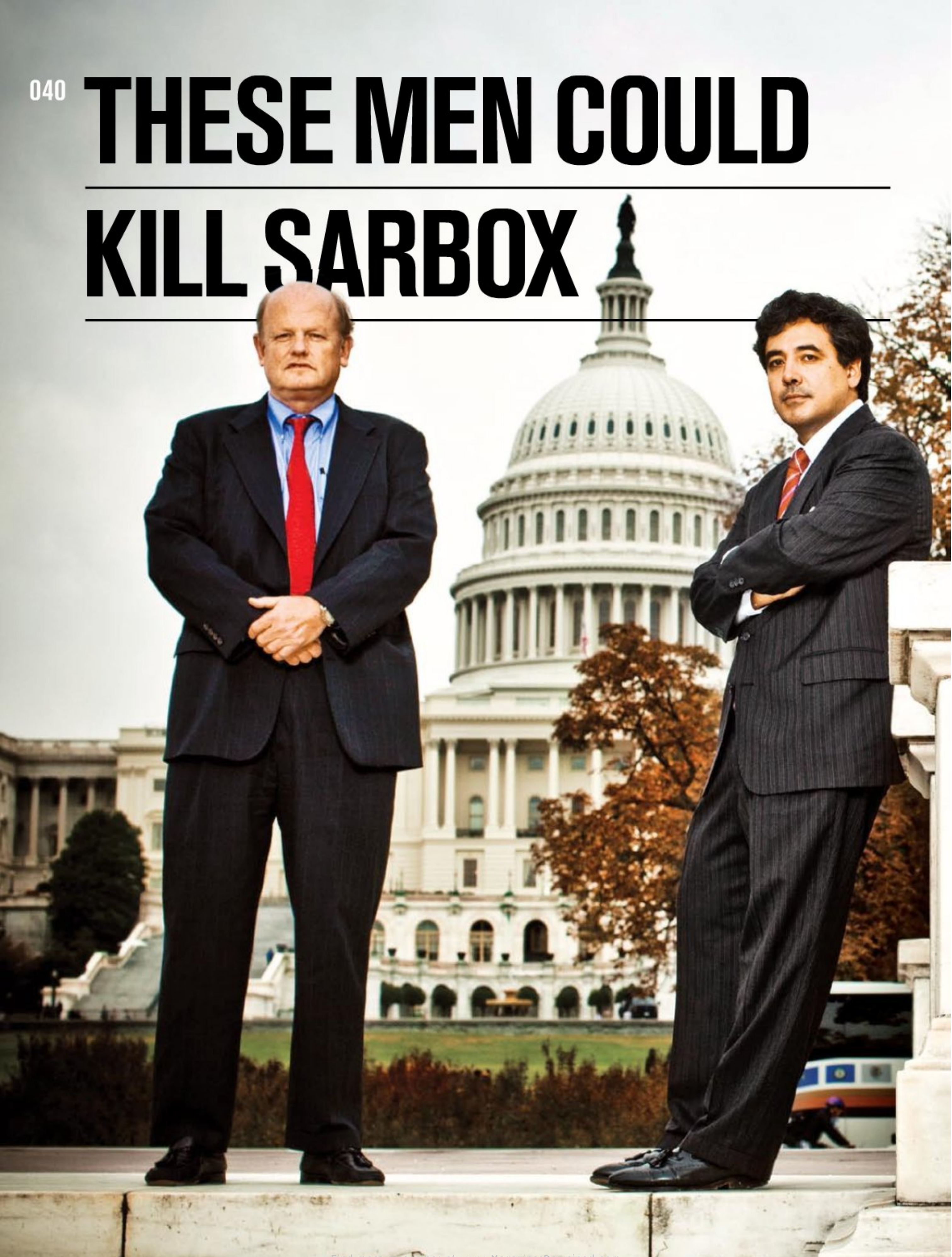
Muni Mayhem

In its ongoing coverage of the crisis in Jefferson County, Ala., Bloomberg reported on Nov. 13 that the municipality sued JPMorgan Chase and a former city official. The county alleges that the bank and ex-official refinanced $3 billion of debt to generate fees and interest payments: "This is a suit...against those who have brought the county and its citizens to the brink of financial disaster while lining their own pockets." JPMorgan says the claims are "meritless."

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THESE MEN COULD KILL SARBOX



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By Theo Francis

Photograph by Stephen Voss

Two tenacious Washington lawyers have the Sarbanes-Oxley Act in their sights—and they just might take it down

From the marbled corridors of Congress to the tony salons of Georgetown, liberal lawmakers are abuzz with ideas on how to rein in U.S. corporations. Yet over in the courts, two conservative lawyers are mounting a serious challenge to a law, enacted earlier in the decade, that imposed tough restrictions on American businesses. A ruling in their favor could deal a serious blow to the pro-regulatory movement in Washington.

Michael A. Carvin and Noel J. Francisco, partners at the giant law firm Jones Day, are taking on the Sarbanes-Oxley Act of 2002, the controversial anti-fraud legislation passed after the last big wave of corporate scandals. The two are representing Brad Beckstead, the head of a small auditing firm in Henderson, Nev., who is suing the Public Company Accounting Oversight Board, the panel created by SarbOx to make sure auditors are doing their jobs. Beckstead says the PCAOB picked apart his business in a grueling 2004 audit. "I became the poster boy for what not to do when auditing small companies," he says. The cost of complying with the rules was so great, he claims, that he had to abandon his auditing practice.

Jones Day's Carvin and Francisco relish cases that could limit government

On Dec. 7 the U.S. Supreme Court will hear oral arguments in the case, known as *Free Enterprise Fund and Beckstead and Watts v. PCAOB and United States of America*. A finding for Beckstead could reopen the entire Sarbanes-Oxley Act. Some board defenders fear a victory for Beckstead could even shake the foundations of established bodies such as the Federal Reserve. "The implications are potentially far-reaching," says Gillian Metzger, a Columbia law professor who is supporting the PCAOB board in filings with the high court.

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For Carvin, 53, and Francisco, 40, this is no ordinary case. While the two have staked out a nice business for Jones Day cutting through regulatory tangles on behalf of blue-chip companies such as Electronic Data Systems (EDS) and R.J. Reynolds Tobacco, they're litigating *Beckstead* for free. They were attracted to the case not only for its potential to bring in new corporate clients but also because it fits their political agenda. "If you believe [in] limiting government, you're much more zealous," says Francisco.

CARVIN AND FRANCISCO BELONG TO AN INFLUENTIAL NETWORK OF JUDGES, LAWYERS, REPUBLICAN ACTIVISTS, AND REAGAN AND BUSH VETERANS

Yet that passion hasn't alienated them from Democrats among Jones Day's 2,400 lawyers worldwide. One partner who voted for Obama says he enjoys jousting with the pair over politics. "Francisco has a beautiful mind," he says. "So does Mike."

CONSERVATIVE CONSORTIUM

Carvin and Francisco are important players in what Hillary Clinton might call the vast right-wing conspiracy. They belong to an informal yet powerful web of conservative judges, lawyers, and veterans of the Ronald Reagan and George W. Bush Administrations that has been decades in the making. Even liberals admire the group's reach. "Although I disagree with these people to the core, I have a lot of respect for the way they went about cementing not just their beliefs, but the network of people who shared their beliefs," says Stephen Vladeck, an American University professor of constitutional law.

Both Carvin and Francisco boast impeccable conservative credentials, including big roles in Bush's successful challenge to Florida's Presidential vote in 2000. Francisco, a graduate of the University of Chicago law school, clerked for Supreme Court Justice Antonin Scalia. Perhaps most important, Francisco and Carvin—a law graduate of George Washington University—worked for the Office of Legal Counsel (OLC) under Reagan and Bush, respectively. The in-house law firm to the sitting Administration, the OLC's biggest job is scouring proposed laws and regulations for constitutional potholes—infringements of the President's appointment power, threats by one branch of government to encroach on another's authority, and attempts by executive branch agencies to overstep their bounds. OLC veterans include Supreme Court Justices Scalia and Samuel A. Alito Jr., as well as the late Chief Justice William H. Rehnquist, who was running the office when President Richard M. Nixon tapped him for the court in 1971.

Now the two are fashioning a "Republican OLC in exile," says John Elwood, a partner in the Supreme Court practice of the law firm Vinson & Elkins and a former OLC attorney. The OLC's focus on the Constitution and the balance between Presidential authority and Congress has long informed many of Carvin's and Francisco's arguments. Francisco is invoking the First Amendment in a bid to win Reynolds and other tobacco companies the right to promote chewing tobacco as a safer alternative to smoking. Similarly, when the government recently sought to slap tobacco companies with billions of dollars in penalties under federal racketeering laws, Carvin and Francisco successfully argued that the law didn't allow such penalties without criminal charges—effectively defanging the broader case. Carvin, meanwhile, represented EDS when it was a contractor for securities regulators and it botched the scoring of brokers' exams in 2005. Carvin argued successfully that Congress had protected the regulators—and therefore EDS, their contractor—when it established a comprehensive appeals scheme that precluded lawsuits seeking damages.

ATTACKING REFORM

In *Beckstead*, Carvin and Francisco are taking on their boldest challenge yet. The PCAOB was established as an independent nonprofit largely to let it pay market wages for its workers rather than civil servant salaries and to shield it from political

THE MAKING OF TWO ANTI-REG BULLDOGS



Mike Carvin, 53

Law School: George Washington University

Conservative cred:

1982-88: Worked as an attorney in Justice Dept.'s Civil Rights Division during the Reagan Administration. Capped off Reagan years as a high-ranking attorney in the Office of Legal Counsel.

His role in the 2000 recount: Argued Bush's case before the Florida Supreme Court.

Data: *BusinessWeek*



Noel Francisco, 40

Law School: University of Chicago

Conservative cred:

1996-97: Clerked for conservative Judge J. Michael Luttig, Fourth Circuit Court of Appeals. Followed up with clerkship for U.S. Supreme Court Justice Antonin Scalia.

2001-05: Worked first in White House Counsel's Office in the Bush Administration, then at the Office of Legal Counsel.

His role in the 2000 recount: Helped develop a key element of a brief that won Bush unanimous victory in the case's first trip to the U.S. Supreme Court.

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Accountant Beckstead says SarbOx killed his auditing business

ERIC MILLETTE

influence. In 2004 seven PCAOB auditors descended on Beckstead & Watts to pore over its practices. The result was a detailed report listing deficiencies based on the SarbOx rules. Beckstead penned a spirited response, but he says the cost of complying was too great and he had to shut down his auditing practices.

The Free Enterprise Fund, a conservative group founded by anti-taxation crusader Stephen Moore, took interest in Beckstead's plight. When the fund introduced Beckstead to Carvin, the accountant jumped at the chance to sue. (So did Carvin; he and Francisco agreed to stay with the case even after the fund ran out of money to support the litigation.)

Carvin and Francisco charge that the PCAOB is unconstitutional. They argue that the Constitution requires Presidential appointment of the top members of so powerful a body as the PCAOB. Yet, they point out, PCAOB members are appointed by the Securities & Exchange Commission. The lawyers also contend that PCAOB's members are largely beyond Presidential discipline because of a variety of restrictions on their removal. Since the Constitution requires the President to "take care that the Laws be faithfully executed," the President must have the widest possible power to remove those responsible for the government's executive functions, they say. The PCAOB argues that it is constitutional. Backers say its members are low-level officers who don't have to be appointed by the President, and say the President and the SEC have plenty of tools to govern the board.

A ruling for Beckstead could invalidate a host of post-Enron reforms. Because of a drafting quirk, the entire body of Sarbanes-Oxley might fall if a significant legal flaw is found anywhere within the legislation, say some attorneys. Other lawyers say a ruling for Beckstead could call into question the legitimacy of other regulators' appointments. For example, the fixed terms of the Federal Reserve's seven governors limit the President's ability to remove them—a situation that theoretically could be proved invalid if the court sides with the broadest arguments being made by conservative lawyers filing briefs in the Beckstead case.

But even a less sweeping opinion would probably give Congress time to fix the law so that it conforms with the Constitution. That would give critics a chance to reopen SarbOx to debate—and even make major changes. "You create tremendous advantages for the minority [party] to get substantial amendments," Carvin says. Separately, the House is considering exempting small companies from key provisions of SarbOx.

After the Beckstead case, Carvin and Francisco plan to turn their attention to the Obama Administration's aggressive reform agenda. "The stakes are enormous, and you have agencies getting into all kinds of areas they've never gotten involved in," Carvin says. The two lawyers are already talking with potential clients who fear losing millions in executive pay at companies receiving federal assistance, and they're pondering a challenge to various pro-union executive orders by President Obama. More cases are likely. Says Carvin, "it's a target-rich environment." |BW|

Business Exchange

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Financial Regulation and the Court

A Supreme Court decision on *Free Enterprise Fund and Beckstead and Watts v. PCAOB and United States of America* could help determine just how independent—that is, free of Presidential control—the regulator of systemic financial risk could be, argues David Zaring, a legal expert at the Wharton School, in a *Washington Post* blog. If the President can't appoint or remove the regulator's board members, the case "will be a good benchmark to evaluate whether the regulator will pass constitutional muster," Zaring says.

To read Zaring's post, go to **bx.businessweek.com/financial-regulation/reference/**

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COUNTRY REPORT

HEALING CHILE'S MALAISE

By Geri Smith

Despite decades of economic growth, average citizens are dissatisfied—and want better schools and more opportunities



SANTIAGO

Valeria Garcia has come a long way in the past two decades. As a high school dropout, she lived in a wooden shack with a dirt-floor kitchen and a tin roof in San Ramón, one of the Chilean capital's roughest neighborhoods. But at age 33 she went back to high school and then earned a degree in psychology from a local university. For seven years she commuted an hour each day by bus to classes, all the while taking in washing to make ends meet.

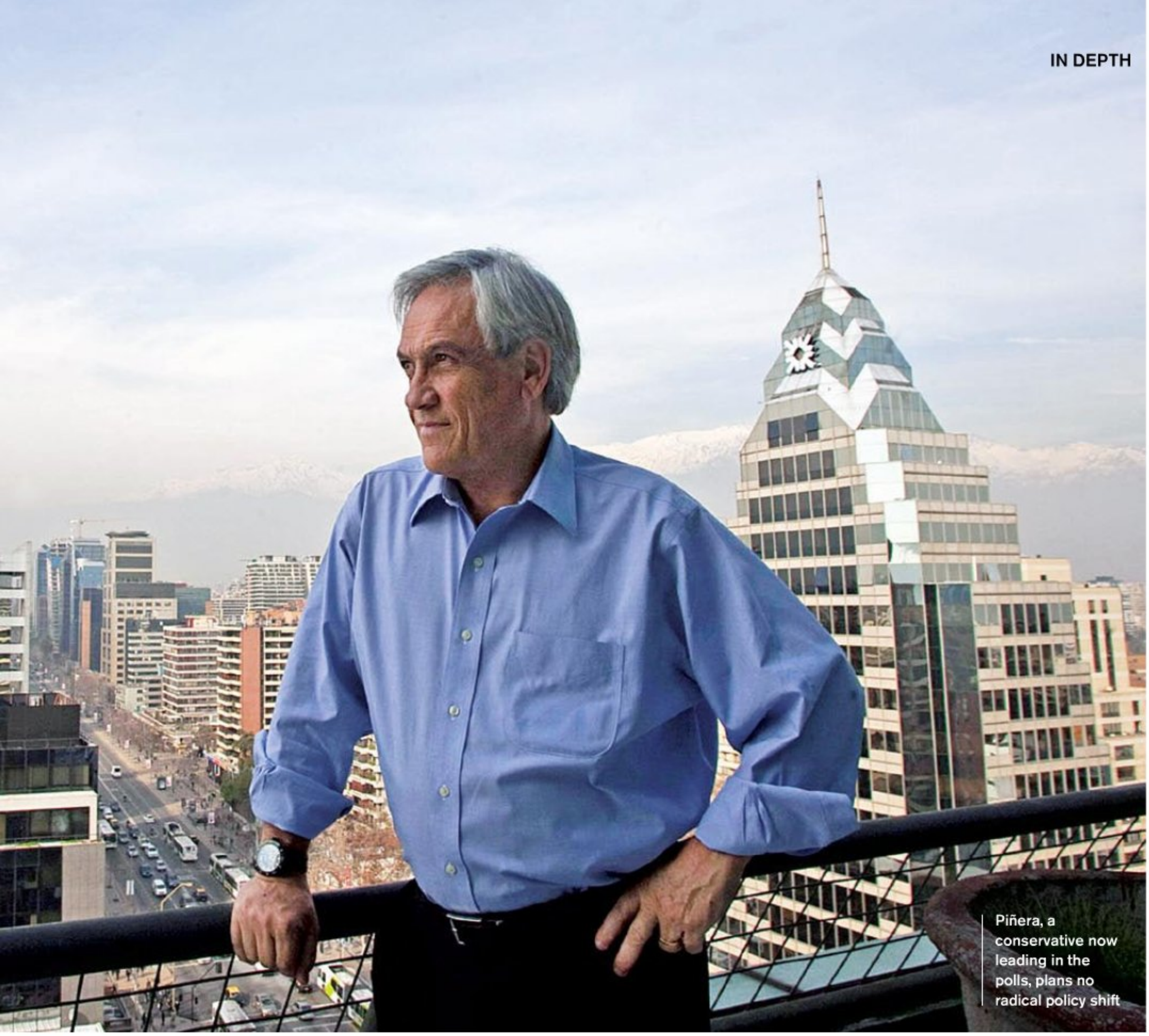
Now 52, Garcia is a psychologist at a center for battered women and is sending her children to college with no government aid. Her $1,200 monthly income disqualifies her for financial assistance, although she still lives in San Ramón, a desolate expanse of makeshift houses and vacant lots. "If I'm now considered middle-class, why do I feel so poor?" she says, looking around the four-room cinderblock house she shares with her three daughters. "The world thinks Chile is successful, but many Chileans can't do much more than work, sleep, and eat. People aren't satisfied."

Chile has come a long way since 1990, when democracy was restored after 17 years of military rule. The economy has been one of the world's fastest-growing, inflation is a distant memory, the poverty level has fallen to 13% from 45%, and per capita gross domestic product has quadrupled, to $10,100.

Yet like Garcia, many Chileans feel a certain malaise. They know their country is one of the most prosperous in Latin America due to fiscal discipline and the profound free-market reforms of the past 30 years. But Chile's explosive, Asian-style growth of the 1990s has given way to expansion averaging just 3.5% annually this decade. And despite efforts to diversify, volatile copper earnings continue to account for more than half of total exports. So Chile's leaders are seeking to reduce that dependence and nurture a knowledge-based economy via better schooling and more innovation.

For the well-to-do, it's business—and pleasure—as usual. Glittering new office towers and luxury apartment complexes abound in Santiago's wealthy neighborhoods, and on Sundays well-heeled families flock to the Club de Polo San Cristóbal for a sumptuous buffet of prime rib and Alaskan king crab. They dine overlooking immaculate fields where thoroughbreds

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Piñera, a conservative now leading in the polls, plans no radical policy shift

are groomed for afternoon races. But in the sprawling, dusty communities where Chile's nascent middle class lives, health clinics, parks, and public transportation are in short supply. In spite of its progress, Chile remains a class-bound society of haves and have-nots. "Chileans have advanced, but not as much as they'd like, and those who feel left behind are bitter," says Marta Lagos, an economist who heads Latinobarómetro, an opinion research firm.

MORE DYNAMIC

That's translating into trouble for the Concertación, the center-left coalition that has governed Chile since General Augusto Pinochet's military junta stepped down. The coalition of Socialists, Christian Democrats, and Radicals risks losing the Dec. 13 presidential election. Leading the polls is Sebastián Piñera, a conservative billionaire who controls LAN Airlines, the flagship carrier. The 59-year-old Piñera doesn't plan to radically change the successful mix of fiscal and monetary policies or poverty-zapping cash handouts that the Concertación has championed. But voters seem to feel he is more dynamic than the Concertación's candidate, 67-year-old former President Eduardo Frei, and more mature than Marco Enríquez-Ominami, a 36-year-old Socialist who broke ranks with the coalition when it rejected his candidacy. President Michelle Bachelet, a Socialist who can't run for reelection, is wildly popular. But her 78% approval rating hasn't rubbed off on Frei.

On Bachelet's watch, Chile enjoyed windfall profits from record-high copper prices. But instead of spending that money, as other commodity-rich countries did, the government put $20 billion into sovereign wealth funds and invested it, earning average annual returns of 7.2%. That let Bachelet unleash a $4 billion fiscal stimulus, equal to 2.8% of GDP, after the global financial crisis hit. The money was spent on loans to small businesses, subsidies for companies employing young people, financing for low-income housing, and more. "We were willing to take the heat and make an important savings effort when it was not popular to do so," says Finance Minister Andrés Velasco. While the economy is set to shrink by as much as 2% this year, economists expect growth of 3.5% to 5% in 2010 as the world economy revives and copper prices recover.

CLAUDIO REYES/EPA/CORBIS

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Psychologist Garcia: "If I'm considered middle-class, why do I feel so poor?"

A big worry for many Chileans is education. Although 90% of students finish high school, many feel public schools are subpar. Some 40% of high school and university graduates score dismally on reading comprehension tests. And schools are plagued by frequent teacher strikes, including a walkout that kept classes idle for most of November. So low-income and middle-class parents often scrimp or take on debt to send their children to private schools. "Until Chile reforms education, nothing will change," says Manuel José Ossandón, mayor of Puente Alto, a working-class district of 700,000 on the outskirts of Santiago.

He ought to know. Even Puente Alto's top public school suffers from poorly trained teachers and classrooms crammed with as many as 45 students. "The best teachers want to work in private schools, which pay better," says Sandra Urrutia, principal of the sprawling brick complex with 2,400 students from kindergarten to high school.

TAX BREAKS FOR STARTUPS

Last year, 60,000 Chileans joined a new nonprofit group called Education 2020 that is lobbying for better schools. Among the group's goals are higher spending on education, mandatory teacher testing, and tighter accreditation standards. "How do people expect Chile's economy to grow 7% a year if nearly half of its population is functionally illiterate?" asks Mario Waissbluth, an engineering professor at the University of Chile and founder of Education 2020. "Chile has reached a glass ceiling, a limit to its future growth unless it does something quickly to improve its human capital."

A second big worry is a lack of innovation. While Chile ranks well on innovation vs. its Latin American peers, the government knows it must do more to attract higher-end foreign investment. The National Innovation Council for Competitiveness, a public-private partnership, is trying to increase ties between universities and businesses to promote biotech, green energy, and technology startups. And the government has introduced generous tax breaks and subsidies to help build such businesses.



Those incentives helped lure U.S. tech firm Synopsys to Chile. The company, which designs software for chipmakers such as Intel, opened a research center in Santiago three years ago. Chile's economic development agency, Corfo, pays up to $25,000 for training each new employee, money Synopsys uses to send hires to its Mountain View (Calif.) headquarters for orientation. The newcomers seem to like the culture. Synopsys' 28 engineers, who earn about half what their U.S. counterparts do, come to the office in T-shirts and shorts. "We wanted to create an atmosphere of creativity and innovation," says General Manager Victor Grimblatt. Last year, Synopsys Chile exported $1.2 million in services, and three of its engineers applied for a U.S. patent.

Drive 75 miles west toward the port city of Valparaiso, and you'll find another leg of Chile's efforts to build a knowledge economy. There, Evalueserve, a New Delhi outsourcing firm, employs 160 Chileans who provide business analysis for companies worldwide. "I feel like I'm exposed to the heart of the international financial system," says Santiago Tapia, a 32-year-old who analyzes beverage and food companies for a global investment bank. Tapia says he's "living the American Dream," with a modern apartment two blocks from the ocean, a late-model Hyundai, and his fast-paced job with co-workers from India, Japan, China, and a half-dozen other countries.

Thanks to government-subsidized training and free rent for five years, Evalueserve says its costs in Chile are half what they would be in the U.S. and just 50% more than in India. The company plans to triple its workforce in Chile in four years. Corfo, the economic development agency, says outsourcers in Chile will export some $950 million in services in 2009. Within five years the agency aims to boost that to nearly $3 billion.

Tapia: The young data analyst is "living the American Dream" at Evalueserve

If successful, the effort will bring jobs needed to sustain growth as the country moves away from its dependence on copper exports. Until investments in education and innovation pay off, though, many Chileans plan to send their political leaders a message this election: There's no time to waste making sure average citizens enjoy real opportunities. Marta Cecilia Carvacho, a 42-year-old single mother who earns $585 a month as a maid, sells ice cream on weekends at a street market so she can send her 13-year-old son to a private school. "I know we're all better off now than we were 20 years ago," she says. "I can more or less feed and clothe my son and give him shelter. But there is more to life than simply surviving. I want my son to develop as a human being, to participate fully in Chile's promise, and I don't see that happening now." BW

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Stories of Growth through Innovation

Today, the path to a healthy global economy is green and runs through Japan.

Doctor, how's our patient? Well, he's still down, but showing signs of life. We're talking about the global economy of course, and by most accounts it's on the road to recovery and looking for opportunities in Japan.

In Japan today, forward-thinking companies will find some of the world's most exciting research and development going on in environmental or "green" technologies, as well as a government that's devoted to supporting Innovation in the sector.

Japan is number one in ISO14001 certifications, and is among the world leaders in energy-saving technology patents—three times as many as the U.S.A. or Europe. Powered by R&D in fuel cells, solar power technologies and waste treatment, Japan's "ecobusiness" is expected to grow to U.S. $483 billion by 2010 and to U.S. $596 billion by 2020.

Japan's ecobusiness boom can be traced to the Basic Law for Establishing a Recycling Based Society, which was enacted in 2000. The law clearly acknowledges the responsibilities of the central government and businesses as waste generators and encouraged regulations to curb global warming and ensure a safe, stable energy supply.

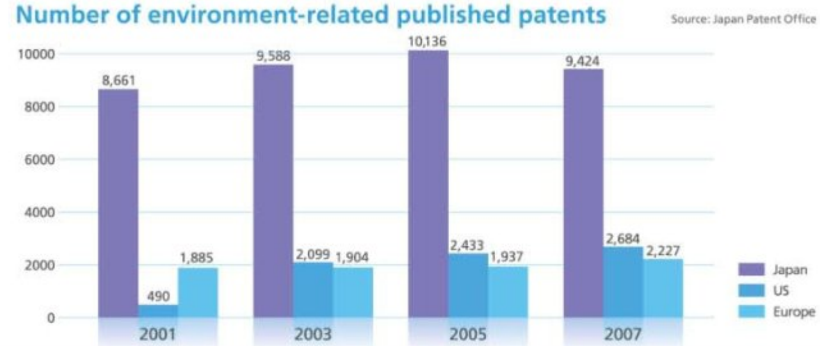


Solar energy technology, particularly photovoltaic cell development, is an area where Japan is experiencing vigorous growth. For several years, Japan has been a among the world leaders in installation of photovoltaic (PV) systems and solar power generation.

Perhaps that's why the Japan subsidiary of DuPont recently established a PV Lab facility at the DuPont Electronics Center in Kawasaki City, Kanagawa Prefecture, Japan, to serve as a research and development base for the Asian region. The facility will specialize integrating development of various

Number of environment-related published patents

Source: Japan Patent Office



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—Made in Japan.

metallization pastes for the thick film materials used in photovoltaic solar cell production.

While DuPont has research facilities throughout Asia, from China to India, the main roles of those locations moving forward will be to provide technical support for the R&D taking place in Japan.

According to an article in Nikkei Electronics (Nikkei Business Publications) published in autumn of 2008, Japan was chosen for DuPont's regional PV Lab because: 1) Japan is a leader in the solar cell market, 2) Japan has numerous materials manufacturers capable of partnering with DuPont, and 3) compared with other Asian countries, Japan has a better awareness of intellectual property rights protection.



Also betting large on the lively photovoltaic technology market in Japan is Evonik Industries, the German industrial-chemical and energy group—a global leader in specialty chemicals, hard coal power generation and renewable energies. A presence in all major silicon based photovoltaic technologies, Evonik produces silanes, which are the key chemical compounds used in the production of photovoltaic solar cells.

In Japan, Evonik has teamed up with Taiyo Nippon Sanso Corporation, investing U.S. $200 million to build an integrated production facility in Yokkaichi City for the production of monosilane. Construction of the new facility will begin in late 2009 and start up is scheduled for 2011.

Monosilane is an industrial gas that is used to form silicon films on thin film silicon solar cells and a variety of electronic devices in the semiconductor industry. The partnership will allow Evonik to move into the production of electronic-grade monosilane for thin-layer photovoltaic cells, flat screen monitors and semiconductors.

With global warming in the news nearly every day lately, a lot of attention is being focused on alternative fuels and new ecobusiness models, but that's not all the research and development that's going on in Japan.

People are living longer healthier lives, and that places skin care and anti-aging products at the forefront of R&D in the healthcare and cosmetics industries today. And Japan has long been a global testing ground for skin care products.

According to research by cosmetics giant Estée Lauder, Japan is easily the largest skin-care market in the world. The Clinique skin-care brand has been in Japan for 30 years now and is the company's top brand here, accounting for 25% of the country's high-end cosmetics market.

Estée Lauder, which has 2,500 employees in Japan, estimates that Japanese women use, on average, seven skin-care products four to five days a week and about eight make-up products a week. Today, anti-aging products comprise the fastest growing market segment in cosmetics.

Research and development of Estée Lauder's most advanced anti-aging products is conducted the Kobe Skin Research Institute in Kobe City, Japan. The facility, which shares data with the Anti-aging Research Center of nearby Doshisha University, is focused on discovering how aging spots are formed and learning how to repair damaged cells.

Whether the focus is on learning how to protect against the power of the sun or developing better ways to harness its energy, Japan has the foundation for growth. And with a government that's receptive to ecobusiness and seeking foreign investment, Japan might be just what the doctor ordered.

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INNOVATION GOES DOWNTOWN



By Pete Engardio

From Barcelona to Seoul, urban science parks are being built to lure the best minds and the industries of tomorrow

INSIDE INNOVATION

In its heyday decades ago, Olivetti employed nearly 3,000 workers in a hardscrabble section of Barcelona making typewriters. Drop into the former factory today, and you'll likely find young professionals perched on comfy foam couches talking business in a mix of languages amid brightly painted walls and exposed wooden beams. Glass-enclosed conference rooms are filled with students taking seminars on how to write business plans or develop marketing campaigns. Tacked to a bulletin board next to the canteen are news reports about the latest venture to snag investors.

Reopened three years ago as a high-tech business incubator, the four-story concrete-and-glass structure now hosts 55 startups creating everything from bike helmets with built-in air bags to an online audio-search service that some analysts think might be "the Google of music." The converted factory also houses the home office of 22@Barcelona, which oversees a sprawling science park of university campuses, research institutes, and corporate labs that boosters hope will turn the Mediterranean city into one of the world's great creative hubs.

Say "science park" to most Americans and they probably will think of beautifully landscaped campuses of low-rise buildings on the outskirts of a city, where researchers commute to their cubicles each morning and fight the evening traffic to return home. For 50 years the prototype was Research Triangle Park—an 11-sq.-mile district snuggled into the piney hills outside of Durham, N.C., with such multinational tenants as IBM and GlaxoSmithKline.

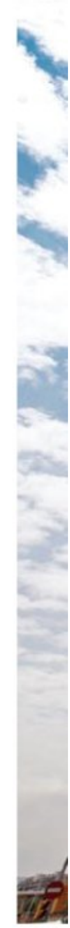
No longer. Today's high-tech meccas are being constructed deep inside major cities. Michael Joroff, an urban-planning guru at Massachusetts Institute of Technology, dubs them "new century cities." Their goal, says Joroff, an adviser to projects in South Korea, Britain, Sweden, and Abu Dhabi, is to "kick-start high-priority industries with new spaces where companies and universities can work together and develop the next generation of workers."

Planners also hope to tap into the "new urbanism" movement by offering plenty of amenities where scientists, entrepreneurs, and creative types from an array of industries can intermingle and, with a bit of serendipity, cross-pollinate ventures. "To be a neurocenter of the knowledge economy, fiber and telecom are not enough," says Josep Miquel Piqué, 22@Barcelona's chief executive. "You also need things like good food, wine, and aesthetics."

The scale of some of these urban schemes is jaw-dropping. Spain's 22@Barcelona (the name comes from an industrial zoning designation) involves transforming 115 blocks of the city to house more than 1,000 international media, IT, and medical technology companies that are expected to employ 150,000 in 15 years. Singapore is spending some $10 billion on futurist architecture for a megadevelopment called One North, which integrates new research and development complexes and "living laboratories" for biotech, advanced materials, and medical services. Seoul hopes Digital Media City, which is rising near an old railroad depot and dump, will have 120,000 workers and 2,000 companies by 2015.

Some older U.S. tech clusters are trying to adapt. Industrial parks set up in the 1960s outside San Jose to cater to the then-nascent electronics industry are adding amenities including housing, shops, and bike and hiking trails to turn them into fuller communities. Research Triangle Park is dolling itself up, too. "This is about making this place consistently more attractive to the brightest minds in the world," says Rick L. Weddle, CEO of the Research Triangle Foundation, which owns the park.

Midsize industrial cities see downtown parks as redevelopment tools. Winston-Salem, N.C., hit hard by the decline of the tobacco, textile, and furniture industries, has converted a building once owned by R.J. Reynolds



The converted factory housing 22@Barcelona hosts 55 startups

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Piqué of 22@Barcelona stresses access to the finer things in life

into the headquarters of a research park specializing in biomedicine. Meantime, Sheffield, England, a cradle of the Industrial Revolution, is launching an ambitious redevelopment to position itself as a hub for advanced manufacturing, design, and new media.

Skeptics warn the trend is getting overdone and that some science parks will flop. "Every city and state with a university wants to jump on this bandwagon," says Peter B. Calkins, who heads the science and technology business of Cleveland-based developer Forest City Enterprises. "Not all are well-conceived." Forest City built and manages University Park in Cambridge, Mass., which is filled with biotechnology companies, and is building a major complex near Johns Hopkins University in Baltimore. The payback for such projects can be long, Calkins notes. Despite its proximity to Massachusetts Institute of Technology, University Park needed more than a decade to gain traction with corporate tenants.

Many new parks going up in China, the Persian Gulf, and parts of the U.S. are "just big real estate developments, rather than investments in people and innovation," says Anthony Townsend, who tracks science parks for the Institute for the Future, a think tank based in Palo Alto, Calif. Often, he says, inventors just need cheap space in a stimulating environment.

Other analysts question whether grand projects are really needed in an era when creative types increasingly collaborate over the Internet. The splashy projects also seem to fly in the face of another development. Cheaper telecom and advances in videoconferencing and Web 2.0 tools are making it ever easier for inventors to work together across time zones and continents. IBM has said some 40% of its employees don't work in their offices on any given day. Companies also are outsourcing more design and engineering work to places such as Russia and India.

But even proponents of the virtual workplace agree there are big advantages to having dense concentrations of creative minds in the same place. "The innovation bandwidth in a cafeteria is significantly greater than the bandwidth for



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Seoul's Digital Media City expects 2,000 companies by 2015

innovation over the Internet," says business strategist Don Tapscott, coauthor of *Wikinomics: How Mass Collaboration Changes Everything*.

That is the idea behind Singapore's One North project. One section is called Biopolis, an R&D complex for life sciences. Its first two phases of buildings already are filled with 1,000 scientists working in seven public research institutes and the labs of such big pharmaceutical companies as Novartis and Eli Lilly. By the time Phase III is finished in 2010, Biopolis could encompass 4.5 million square feet and employ up to 5,000 researchers. Five minutes away is Fusionopolis, a soaring 24-story structure designed by Japanese architect Kisho Kurokawa, co-founder of an avant-garde movement called Metabolism. The tower is a home for media, communications, and information technology companies. Office clusters for health and wellness services, data storage, and high-performance computing are going up, too.

To draw creative talent, Fusionopolis has trendy restaurants, athletic facilities, and apartments equipped with networked appliances that residents can try out. "We want a location for people to live, work, and play," says Yeoh Keat Chuan, biomedical sciences executive director of Singapore's Economic Development Board. "We want to be a window on what an Asian city of the future will look like."

Seoul's Digital Media City is one of the most grandiose efforts at nurturing a creative community. Today the new district along the Han River doesn't yet look much like other Asian boomtowns. It consists of only a few dozen modern offices housing 230 companies and apartment towers lining broad avenues. Over time, Seoul officials envision Digital Media City swelling into a Hollywood of sorts for everything from cultural programming to electronic games and interactive workplace software. Already, for instance, creators of experimental video can project their digital images onto four huge screens on building exteriors.

Four broadcast companies and LG Telecom have opened big operations there, while seven newspapers are building towers. Offices also are filling up with small and midsize companies. Roughly 40 design firms, including Italian design house Be-On Creative, have moved in. Some were drawn by free rent, part of the city's strategy to promote the industry. But Daniele Testa, Be-On's Seoul director, says location was key. "I would not have based myself in a science park far removed from urban life even if I were given a rent-free office," Testa says. "We designers must be connected with what's going on in big cities." | BW |

–With Moon Ihlwan in Seoul and Andy Reinhardt in Barcelona



Singapore is investing some $10 billion on R&D complexes for high tech

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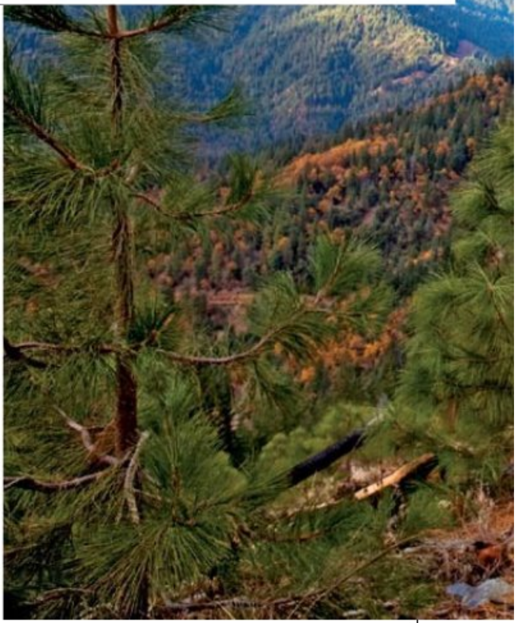
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WHAT'S NEXT

ECONOMICS & POLICY

A Big Loophole In Cap and Trade

How companies may be rewarded for green projects they already had in the works



PETER DASILVA

Sierra Pacific CFO Emmerson says offsets fit well with "intensive forest management"

By Ben Elgin

Nearly 3,000 miles from the U.S. Capitol, where lawmakers are debating landmark climate legislation, a crucial aspect of the national campaign to limit greenhouse gas emissions is taking shape at the headquarters of Sierra Pacific Industries.

Situated on the banks of the Sacramento River, Sierra Pacific is California's largest nongovernment landowner and timber harvester. The privately held company, which has estimated annual revenues of $1 billion, says it will manage trees on 60,000 acres of its land in a way that will soak up more carbon dioxide and slow global warming. In exchange, it could receive about $10 million over five years via the sale of "carbon offsets"—financial instruments that would play a vital role in the proposed "cap-and-trade" system at the core of pending climate legislation.

The buyers of Sierra Pacific's offsets—manufacturers, power companies, and other sources of greenhouse gases—would be allowed to continue some of their emissions on the theory that the pollution will be balanced out by the preservation of Sierra Pacific's CO_2-consuming trees. This is one way cap and trade is supposed to encourage environmentalism without unduly inhibiting industry. The term refers to the strategy of setting an overall limit on emissions and allowing companies to use market trading to meet the cap.

"The carbon model fits very well with intensive forest management," says Mark Emmerson, Sierra Pacific's CFO, during an interview in a company conference room adorned with blond Douglas fir paneling. "Every year, we end up with more trees in the ground than we began with."

QUESTIONABLE VALUE

But there's a hitch: Long before considering the offset plan, Sierra Pacific had already agreed to grow more trees. In other words, the offsets may not result in any new conservation. The forestry giant could reap a windfall while industry continues to pollute.

Sierra Pacific's plans illustrate a potential weakness in the cap-and-trade approach, one that has already cropped up in Europe, where the strategy has been used for several years: If offsets are not policed stringently, they will do little to curb global warming.

In June the House of Representatives narrowly approved a bill that aims to cut heat-trapping emissions 17% by 2020 from 2005 levels. Several Senate committees are working on similar legislation; all of the versions encourage use of offsets from such U.S.-based projects as those that replant forests or capture methane from dairy farms. If a final bill emerges, President Barack Obama is expected to sign it.

Purchasing offsets that represent someone else's commitment to reduce emissions is generally much less expensive than renovating a factory to make it green-friendly. But there is a drastic shortage of projects in the U.S. that would generate offsets. And regulators may feel pressure to weaken rules to allow more offsets into the system.

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lion tons of carbon dioxide over the next five years—"in excess of what would have otherwise occurred," the company claimed. In a separate statement, California Governor Arnold Schwarzenegger said the effort would be equivalent to removing 300,000 cars from the road for a year.

A close look at Sierra Pacific's plans reveals that the company may create less additional environmental benefit than advertised. Under long-standing California conservation rules—which predate requirements related to global warming—the company filed a plan in 1999 committing to how it would conduct logging over the next 100 years. Sierra Pacific estimated that the volume of trees on its land, measured in conifer timber feet, would nearly triple, from 17.8 billion in 1999 to 50 billion in 2079.

In carbon-project documents released in early November, Sierra Pacific is proposing to seek credit—and get paid—for some of the same increased volume of trees it had promised in 1999.

Sierra Pacific executives object to the question of whether their offset sales will result in additional environmental protection. "We don't have to do what we said we were going to do [in the 1999 state forestry filing] until we sign the carbon agreement," says Edward C. Murphy, a Sierra Pacific forest manager. "Because we were smart enough to figure out how to increase carbon [reduction] before it became a rule, we shouldn't get credit for

California, a trailblazer on climate rules, enacted its own global warming law in 2006. It seeks to reduce greenhouse gas emissions to 1990 levels by 2020. How California fares could foreshadow the fate of any national cap-and-trade system.

LESS THAN ADVERTISED

After deliberating for two years, the state adopted the latest rules for forest offsets in September. "Our purpose is to make sure there is environmental integrity," Gary Gero, president of Climate Action Reserve, a Los Angeles nonprofit charged with creating the rules, told a luncheon of state legislative staff members in Sacramento in October. "If someone says they've reduced 1 ton of greenhouse gas emissions, there [should be] legitimacy to that claim."

The program has already sparked the sale of offsets in anticipation of its 2012 start. "The protocols work with our business," says Neal Ewald, vice-president and general manager for California operations at timber company Green Diamond Resource.

Sierra Pacific issued a press release in September about its 60,000-acre project, constituting 3% of the company's landholdings. The endeavor would absorb an additional 1.5 mil-

SNAPSHOT OF A CLIMATE BILL

The main provisions in legislation sponsored by Senators John Kerry and Barbara Boxer:

Overall greenhouse gas reductions: 20% by 2020; 83% by 2050 (compared with 2005 levels)

Cap and trade: Regulated industries purchase permits to emit greenhouse gases; permits can be traded

"Offsets": Companies can comply with new restrictions by paying others to reduce emissions

Reduction methods: Include expanding forests and eliminating methane from landfills and coal mines

Nuclear option: Bill designed to promote more use of nonpolluting nuclear power

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it? ... It's a nonsensical question."

Other offset project developers concede that the approach is a work in progress. Chris Kelly, California program director of the Conservation Fund, a nonprofit in Arlington, Va., has established two large forestry projects in California's system and has nearly sold out the offsets through 2015, raising an expected $17 million from a range of companies. But Kelly's group had purchased the land in 2004 and 2006 with state-subsidized loans—and with the agreement that it would not intensively harvest the land. Having agreed to preserve the trees several years ago, the fund will be paid for making the same guarantee again.

"We're working with the protocol that the state gave us and followed it to the letter," Kelly says. He argues that it's important to get some kind of climate regulation in place, even if flaws have to be ironed out later: "What California is trying to do is get something out there that we can all work with." | BW |



JEFF HUTCHENS/GETTY IMAGES

CHINA'S SURPRISING CLOUT IN CLEANTECH

U.S. energy players are looking to the mainland for help

By Adam Aston

If President Barack Obama succeeds in pushing through climate legislation in 2010, U.S. electric power companies could end up having to pay around $20 for each ton of carbon dioxide their plants pump into the atmosphere. To reduce their exposure, energy companies are scrambling to perfect technology known as carbon capture and storage (CCS). The key technologies already exist, but the price could be prohibitive: A coal-burning power plant fitted with today's equipment would face recurring costs of about $125 per ton of CO_2 it buried underground, predicts market analyst New Energy Finance.

To help drive down CCS costs, U.S. companies are enlisting unexpected partners—in China. Long stigmatized as an environmental laggard, the Chinese government is funneling resources into green technology, including "clean coal," both to improve its environment and to exploit green markets around the globe. In some key areas, "China is now more advanced," says Armond Cohen, executive director of the Clean Air Task Force, a Boston-based green advocacy group that has linked up a dozen Chinese and U.S. utilities to collaborate on cleaner coal processes.

Beijing is funneling resources into green tech—both to improve its environment and to exploit a growing global market

China Huaneng Group, the nation's largest power producer, is leading the Chinese thrust. Its Beijing Cogeneration Power Plant showcases a system for collecting and compressing CO_2 from a variety of waste gases. The CO_2 is then sold to a bottler that uses it to carbonate soft drinks.

Chinese and U.S. utilities are teaming up to improve clean-coal technology

A bigger carbon-capture operation using the same approach should come on line this year in Shanghai. And this fall, Huaneng signed a technology licensing deal with Charlotte (N.C.)-based Duke Energy, which intends to use many of the techniques at a 630-megawatt facility it is building in Edwardsport, Ind. Set to start operations in 2012, the plant will convert coal into gas before burning it, snaring some CO_2 before it goes up the chimney. Duke aims to bury some of the waste underground.

In a deal announced Nov. 18, America's largest coal producer, Peabody Energy, bought a 6% stake in GreenGen, a $1 billion coal-fired power plant capable of CCS due to come on line in Tianjing in 2011. Being built by Huaneng and a group of other Chinese utilities, the project is also being designed as an R&D center for carbon management technologies. GreenGen shows China can become "the world's leading clean-coal provider," said Peabody CEO Gregory H. Boyce, in a release.

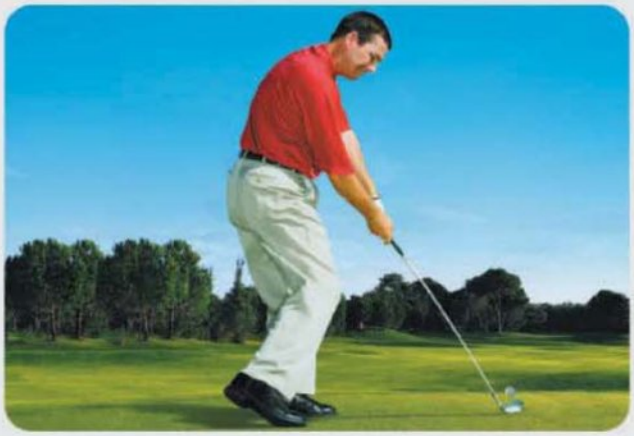
Important know-how is also flowing from the U.S. to China. In September the largest U.S. utility, Southern Co., inked a deal to deploy in China an advanced process called TRIG, for Transport Integrated Gasification. It's especially good at neutralizing low-grade, CO_2-laden coal. "There is a lot [of tech] to share," Cohen says. | BW |

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China's Reverse Brain Drain

Beijing is making progress in its effort to lure back top Chinese scientists working overseas



Tsinghua's Shi is a former Princeton professor and a leading cell researcher

QUENTIN SHIH

BY PETE ENGARDIO

BEIJING

The lab equipment is still being installed in the new life sciences school at Beijing's Tsinghua University. But the hallways are already lined with posters heralding an early achievement: the hiring of Chinese faculty from Stanford, Harvard, and other elite institutions overseas. The mission, says Dean Shi Yigong, a former Princeton professor who is a pioneer in the study of cell death, is to build a world-class research center to "solve the basic mysteries of biology."

Shi is one of the biggest catches in a mounting campaign to lure China's brightest minds back home. Last year, Beijing launched the Thousand Talents Program, offering top scientists grants of 1 million yuan (about $146,000), fat salaries, and generous lab funding.

The goal is to address the biggest roadblock to China's aspirations of becoming an innovation powerhouse: an acute shortage of seasoned research scientists. Accomplished physicists, biologists, and mathematicians—who might produce technological breakthroughs and build key research programs—have long balked at low pay and a university system marred by corruption, cronyism, and lax standards. But now, China's economic boom and surging government investment in research are making mainland university posts more attractive. A decade ago, only 1 in 100 leading Chinese scientists in the U.S. would have considered returning, says Rao Yi, a former Northwestern neuroscience professor who is dean of Peking University's life sciences school. Today, he says, half would. "Now, there is a chance of recruiting the rising stars of Harvard," says Rao.

Higher pay helps, but returnees say the main allure is the chance to build a science program from the ground up. While U.S. labs are struggling for funds, China is expanding. Shi says he earns less in China than at Princeton, where he ran a structural biology lab and helped found a drug-discovery company. But at Tsinghua, he helped design a life sciences program with 1,500 students. So far, Shi has hired 22 scientists from the U.S. to set up labs and has made offers to an additional 15.

HUGE PAY DISPARITIES

Sometimes the perks lavished on returnees can create tension with existing faculty. Wei Jia, an expert in using modern science to study traditional Chinese medicine, says his annual pay package at Shanghai's Jiatong University was worth about $10,000. "It really is irritating that the good pay is reserved for people who are still in the U.S.," Wei says. Last year, Wei left Shanghai to run a new research center at the University of North Carolina, where his package is in six figures.

There are still many holdouts. Carnegie Mellon University electrical engineering professor Jimmy Zhu was tempted by his alma mater in Wuhan with a $140,000 salary, subsidized housing, and more than $1 million to start a lab. But Zhu decided to stay at CMU, in part because he doesn't think "the scientific environment has matured enough to promote real innovation." Also, Chinese officials tend to award grants based on personal connections rather than scientific merit.

Returnees are trying to change that. Tsinghua, for instance, now makes longer-term grants to top scientists, allowing them wider latitude to conduct truly innovative research. And a new curriculum will focus more on problem-solving than rote learning, Shi says. As such changes take root, he says, China should acquire a knack for turning theoretical research into high-tech products. "When you have the right people," he predicts, "changes will happen spontaneously." | BW |

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A Toyota and Lexus dealership in downtown Tokyo

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ECONOMICS & POLICY

Toyota Gets Stuck In a Pair of Ruts

While a strengthening yen eats up profits, the carmaker's reputation for quality is taking a hit

By David Welch and Ian Rowley



TOKYO

For a moment, Toyota Motor CEO Akio Toyoda sounded a lot like an executive from Detroit. Motown brass whined for years about how a cheap yen made Japanese exports hugely profitable. Now that a weak dollar and strong yen are hammering Toyota's profits, Toyoda said in a recent speech, the exchange rates and economic weakness could force Toyota's "capitulation to irrelevance or death."

If he sounds melodramatic, you'll have to cut the new CEO some slack. In October, Germany's Volkswagen passed Toyota in global sales, a fleeting victory for VW but also a sign of Toyota's slipping dominance. Toyoda is also wrestling with an ugly recall in the U.S. involving sudden acceleration in multiple models, underused plants in Japan, and weak earnings that have forced him to cut, among other things, Toyota's once-sacred research and development budget. "The company is in a big storm," says independent auto industry analyst Maryann N. Keller. "Toyota is facing multiple structural problems at the same time."

Take the runup in the yen. When the currency traded between 100 and 110 to the dollar, Toyota's exports to the U.S. were hugely profitable. But every one-yen fall costs the company $400 million a year. In the first half of its fiscal year, which ended Sept. 30, the strong yen has cost Toyota $3.6 billion. It's a big reason why Toyota lost $1.5 billion in the first half.

It doesn't look like Toyota will be getting much relief. Deficit spending in the U.S. is keeping the dollar down. Japan's new government, meanwhile, isn't keen to weaken the currency the way its predecessors did. Japanese Finance Minister Hirohisa Fujii has said he is not interested in manipulating the yen.

Of the vehicles Toyota sells in the U.S., 43% are built in Japan (Honda Motor and Nissan Motor make more of their U.S.-sold cars in North America). If the yen stays strong, Toyota could be pressured to cut capacity at home and build more of its cars elsewhere. It already has plans to eliminate a line at its compact-car plant—and more cuts could be coming. "They have a tradition of trying to maintain factories in Japan," says Michael Robinet, vice-president of research firm CSM Worldwide. "At 90 yen to the dollar, that becomes extremely difficult."

Toyota's reputation for quality has taken a hit, too. This year, for the first time, Hyundai Motor passed Toyota in a J.D. Power & Associates survey that measures how many problems a model has in the first three months. Chevrolet and Ford brands have just about caught up with Toyota in Power's quality survey. Meanwhile, the National Highway Traffic Safety Administration has been looking into rust problems on the frames of older Toyota Tundra pickups and, more seriously, complaints about sudden acceleration in many models, possibly caused by floor mats.

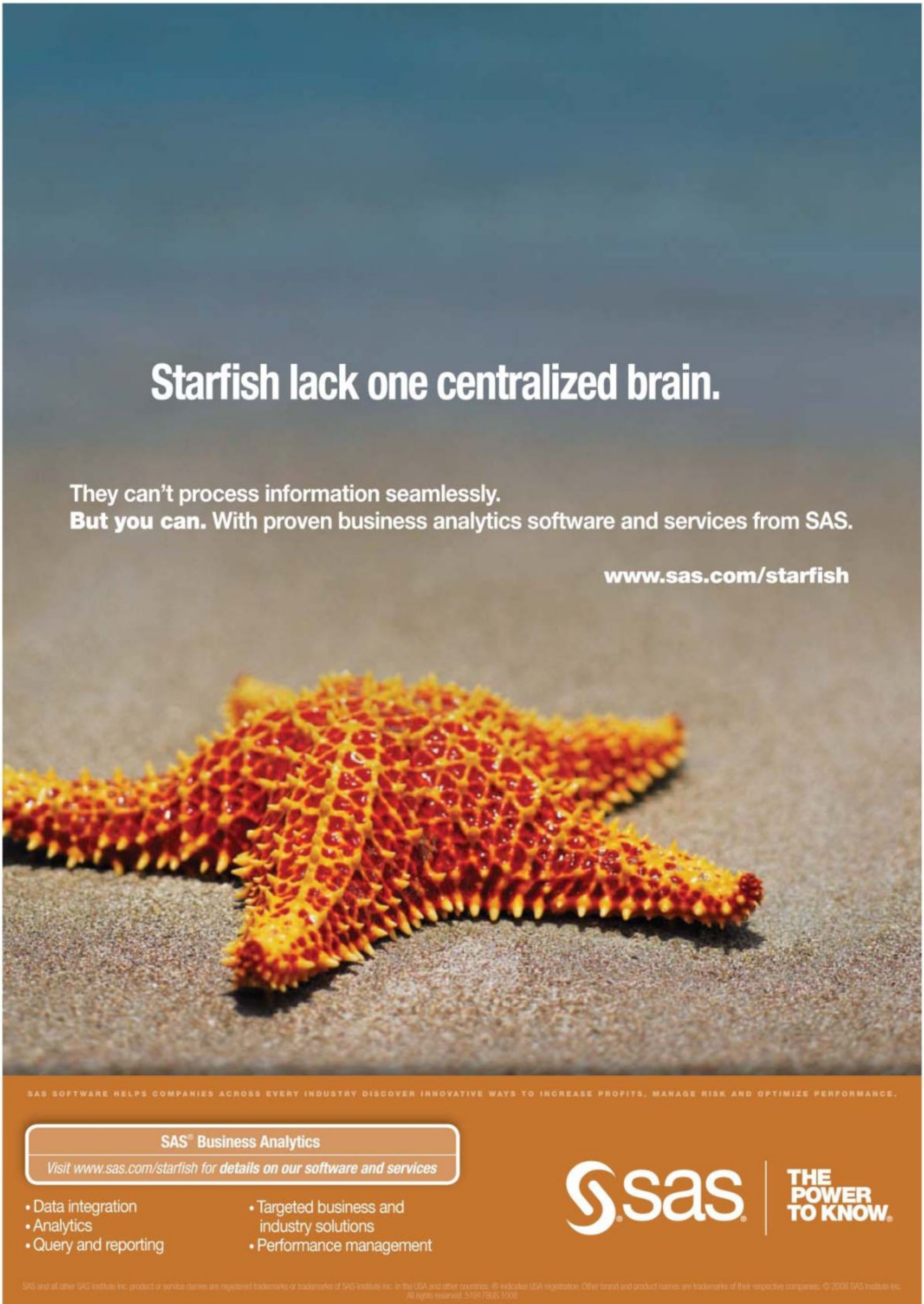
Toyota has been working on a solution since late September but hasn't come up with a remedy. A company spokesman declined to comment. But plaintiffs' lawyers are talking tough. David C. Wright, a partner at Redlands (Calif.) law firm McCuneWright, says he has filed a class action alleging the problem, which has been linked to several deaths, is due to a technical flaw that has nothing to do with floor mats. Even if he is wrong, Toyota has a problem. "They built their success on quality and reliability," says J.D. Power analyst David Sargent. "If something happens to that, it could be very bad for them." As if Toyoda-san needed another headache. |BW|

$3.6 billion

Loss during last two quarters* that Toyota attributed to a stronger yen.

*Mar. 31 to Sept. 30
Data: Toyota Motor

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Abercrombie Bargains For a Rebound

It hung tough on pricing, and teens took a hike. Now can the paragon of preppy coolness woo them back?

By Matthew Boyle

BW 50

Abercrombie & Fitch CEO Michael S. Jeffries is doing something he has long vowed to avoid: He's putting his products on sale. While most of his retail peers slashed prices late last year, Jeffries held fast, citing the "dreadful long-term effects" of entering a discount war that would tarnish a brand he has spent 17 years building into a paragon of preppy coolness.

That strategy has contributed to crippling sales and earnings declines as price-conscious teens have sought bargains elsewhere. Same-store sales plunged 22% in the third quarter, the eighth consecutive period of decline for the New Albany (Ohio) company. Even with Abercrombie reporting a 39% drop in profits on Nov. 13, though, investors pushed the stock up 10%. Expecting worse, many analysts cheered Jeffries' new willingness to adapt to the brutal retail climate.

Abercrombie has built its reputation on provocatively marketed jeans and flannel shirts often two to three times more expensive than anything found on the racks at teen-focused rivals such as Aéropostale and American Eagle Outfitters. The company, which came in at No. 50 on *BusinessWeek*'s list of the top performers this year, does $3.5 billion in sales from more than 1,100 stores, mostly under the Abercrombie & Fitch, surfer-themed Hollister, and Abercrombie Kids banners. While high prices had given the company an aura of exclusivity, not to mention healthy margins, they're now driving many teens away.

But the problem goes beyond the sticker shock. Analysts like Lisa M. Walters, a principal at Retail Eye Partners, say Jeffries has also been a step behind fashion trends this year. "Fashion changed in the teen space," she says, shifting to more detailed, dressy items, "and they didn't change their fashions."

Jeffries, who declined to comment, is now taking action. Abercrombie has marked down items such as jeans and outerwear by 30% to 40%, trumpeting the discounts with e-mails to customers and clearance signs in store windows. "We are reacting to the current environment," he told investors in the Nov. 13 earnings call. Jeffries said he also plans to add lower-priced clothing, especially at Hollister, and has brought in trendier dresses and tops.



Abercrombie's new flagship store in Milan, where the brand remains hot

JUAN CARLOS JONES/CONTRASTO / REDUX

EURO-MOMENTUM

Jeffries is also going on the offensive outside the U.S., where the Abercrombie brand has maintained its cachet. Lines snaked out the door in late October when Abercrombie opened its new flagship store in Milan. The company plans to open two more flagships in Japan and one in Copenhagen, while Hollister stores are also popping up across Europe. Edward Yruma, analyst at KeyBanc Capital Markets, believes that international sales could eventually contribute more than 30% of Abercrombie's total revenue, up from 11% today. "International is undoubtedly a home run," says Randal Konik, analyst at Jefferies & Co.

Abercrombie is also generating more online sales, which increased 11% in the most recent quarter, to $64 million. New Chief Financial Officer Jonathan Ramsden, meanwhile, is keeping a tighter lid on expenses, which have declined over the past few quarters.

But Jeffries faces a tough fight at home. While analysts like Konik believe Abercrombie's fortunes will rise again as consumer confidence returns, others argue that persistently high price tags have taken a toll. As retail consultant Robin Lewis argues: "Once you lose your brand loyalists—and you have to do a lot to piss them off—you don't get them back." |BW|

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Why Drugmakers Don't Twitter

The FDA has so far failed to craft rules clarifying how companies can participate in online discussions

By Catherine Arnst

Some 60% of Americans say that when they need medical information, they turn to the Internet. At least half the group uses social networks to consult one another on symptoms, diagnoses, and treatments, according to surveys on Web behavior. Pharmaceutical companies would like to get in on the conversation, but how do these highly regulated companies twitter and friend without running afoul of federal marketing restrictions?

Nobody quite knows, including the Food & Drug Administration. So the agency held two days of hearings in November to brainstorm about social media rules for drug companies. More than 800 people signed up for the meeting, held in a room that seats half that number, and so many attendees tweeted the proceedings that one of them set up a Web page, www.fdasm.com, to collect all the comments.



JACK BLACK

Those tweets had a common theme: The FDA is taking far too long to figure out Web 2.0, while patients rush to embrace it. "Does the FDA get it?" asks Mark Senak, author of the blog Eye on FDA and a senior vice-president at public relations firm Fleishman-Hillard. If it did, "they wouldn't be having this meeting now, many, many months after it was already apparent how quickly Web communications is changing."

One fear among drug companies is that online interactions with patients might be construed as off-label marketing

The FDA isn't likely to issue rules before mid-2010. That's too long to wait, drugmakers complain. Their customers crave information now, and much of what they're finding online is incorrect. Ann Moravick, president of an advocacy group, Rx4good, that helps nonprofit health groups find industry funding, agrees that "a lot of the sites patients are going to are misleading or filled with errors. There isn't any FDA monitoring at all."

The pharmaceutical industry spent $4 billion on direct-to-consumer advertising in 2008, but only 4% of that amount flowed to the Web—a tiny percentage compared with other huge advertisers, such as auto companies. Drugmakers are holding back for fear of FDA retaliation if they fail to disclose side effects properly, or if their interactions with patients are construed as off-label marketing.

Drug companies did test the waters earlier this year with display ads that popped up on Google and Yahoo! searches. Those efforts ended abruptly in April when the FDA sent letters to 14 companies, among them Eli Lilly and Merck, demanding that the advertisers display side-effect warnings. Search ads don't have space to explain all that, so most companies abandoned the format.

True to the law of unintended consequences, the search ads that remained became less useful to consumers, according to Google. Pharmaceutical companies switched to general, disease-related search ads with no mention of drug brands, and the number of searchers who clicked on the ads for more information dropped dramatically. That's an indication, says Google, that the FDA's policy is making relevant data about drugs more opaque for patients who seek it.

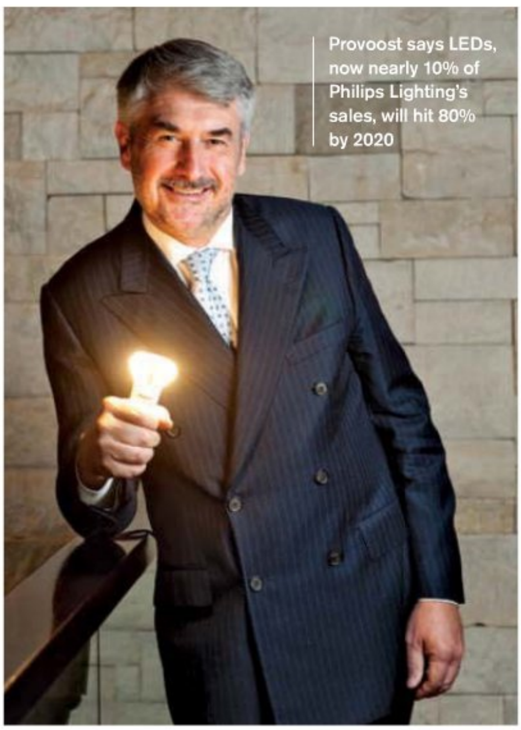
Drug companies are looking for clarity on more than search ads. They want to know if it is their responsibility to sniff out and correct erroneous information about their products on such sites as Wikipedia. Are they responsible for reporting to the FDA adverse drug reactions that might come up in an online comment? And what may they say in a 140-word tweet vs. a YouTube video vs. an online forum? "This isn't just about selling drugs," says Craig M. Audet, vice-president of U.S. Regulatory Affairs for Sanofi-aventis. "It's about listening to patients and giving them what they want." | BW |

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STRATEGY & COMPETITION

A Brighter Idea From Philips

Expecting LED prices to fall, the Dutch giant is teaming with partners to customize next-gen lighting systems



Provoost says LEDs, now nearly 10% of Philips Lighting's sales, will hit 80% by 2020

RICK FRIEDMAN

By Kerry Capell

Light-emitting diodes, those silicon chips that burn brightly but consume far less energy than regular bulbs, are in their infancy as an industry. Sales of LEDs last year were about $2 billion, or less than 3% of global spending on lights. Yet the world's biggest lighting company is already bracing for the day LED components shrivel in value.

Philips is aware that, before long, the cost of LED technology will plunge, as it did for semiconductors 20 years ago. It's a problem the Dutch conglomerate knows well: Its DVD players went through the same dizzying cycle. So even as Philips stakes its future on LEDs, it's working hard to prepare for the technology's commoditization.

In the past five years, Philips has spent $5 billion on acquisitions to ensure it controls every link in the LED chain. It aims not only to manufacture the chips, fixtures, and digital controls for the next-generation technology but also to combine all that into sophisticated systems for such customers as city governments and large corporations. "This is where we go beyond individual components," says Rudy Provoost, CEO of Philips Lighting. "We can create a lot of value by offering entire solutions."

In the past, Philips Lighting simply made bulbs and fixtures without much consideration of the needs of individual customers. Now Philips is working with clients from the start and bringing in outside partners to help design specialized products for them. Last year, Provoost created Philips Lightolier, which links distributors, architects, contractors, and even banks (for financing) to help Philips serve new lighting buyers. "We want to make sure we understand what the end-user needs and that all the pieces are connected," says Philips Lightolier CEO Zia Eftekhar.

One new project is JW Marriott's 34-story hotel in Indianapolis, set to open in 2011. Working with a local designer, Type A Productions, Philips has custom-designed LEDs that fit into the ceiling, engineered the power system and light controls, calculated the energy savings, and offered financing advice. The one-stop service "gave Marriott the confidence to put this new technology into a high-profile project," says Sarena McComas, a partner at Type A.

With 85% of U.S. office buildings still relying on 1970s-era lighting, Provoost is counting on snagging more customers. The recession has been hard on Philips Lighting. In the third quarter, sales were down 13%, to $2.5 billion, and operating profit fell 29%, to $60 million. Even so, Philips is pouring 5% of sales into LED research. LEDs were nearly 10% of the unit's $10.5 billion in sales last year, and Provoost says they will hit 80% by 2020, when the global LED market could be $95 billion.

HOW TO PLAY IT 070

Competition will be fierce. Siemens' Osram, General Electric, Sharp, Samsung, and Cree are all moving into LEDs, although none has made as big a bet as Philips, says Vrinda Bhandarkar, senior analyst at market researcher Strategies Unlimited. Still, she warns: "No matter how big you are, profits will eventually come under pressure. Philips will need to keep innovating." | BW |

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Onysko's soaps are all-natural and feature packaging infused with seeds

INNOVATION & TECHNOLOGY

Selling $8 Soap in An Era of Frugality

Amid recession-ravaged sales, Pangea Organics is battling back with a new deal supplying Sephora

By Jay Greene

SMALL BIZ

In just a few short years, Joshua Onysko went from a vagabond hawking homemade soap from the trunk of his car in Jackson Hole, Wyo., to a hotshot executive whose premium-price skin-care products could be found in Whole Foods markets from coast to coast. Sales at Onysko's Pangea Organics soared to $5.8 million in 2008 from $250,000 in 2005, largely because of clever packaging—seed-infused material that could be planted to grow basil or amaranth rather than dumped in a landfill.

But like a lot of entrepreneurs who came up with a breakout product, Onysko has been struggling to figure out his second act. He may finally have it. After several months of talks with Sephora, the beauty retailer added Pangea to its online offerings in early November, making it one of only two organic brands on the site. (The other is skin-care product maker Juice Beauty.) Sephora plans to test Pangea's soaps, lotions, and creams in a handful of stores next spring and, if all goes well, roll them out at the rest of its 250 North American locations next fall. "They got credit for being a brand that's organic, the packaging looks really great, and it works," says Allison Slater, vice-president for retail marketing at Sephora USA.

CRASH COURSE

Pangea needs a boost. Recession-battered consumers have cut way back on purchases of $8 bars of herb soap and $50 oils, sending total sales down by half this year, Onysko estimates. To cut costs, he outsourced manufacturing to a Denver outfit early this year, laying off 25 employees and leaving his Boulder (Colo.) company with a staff of 14. "It's been like going through an MBA program in nine months," Onysko says.

But Onysko, 32, is a zealot, whose goal is to displace conventional skin-care products. Pangea's line isn't just organic. It uses no petroleum-based ingredients, no synthetic preservatives, and no artificial colors or fragrances. "He's a nut-case, and they don't die easy," says Steve Demos, a Pangea investor and founder of White-Wave Foods, maker of Silk soy milk.

Pangea's rapid rise started with Onysko making natural soaps with his mother a decade ago and, a few years later, marketing them at county fairs in the West. But selling soap wasn't his only aim. Onysko has funneled 5% of profits to underwrite his Pangea Institute, a startup whose goal is to research and teach sustainable business practices.

He approached Whole Foods in 2004 but got shot down for the generic quality of Pangea's packaging. It took design consultancy Ideo of Palo Alto, Calif., to come up with a novel way to convey the idea that Pangea's products were good for the environment: the seed-infused packaging. Onysko couldn't afford Ideo's original price, which was double Pangea's annual revenue, but the firm adjusted its rates for a limited contract in order to develop its own expertise in sustainability.

Pangea's creations often sprout from Onysko's musings. He came up with a new facial scrub, for instance, after watching his girlfriend exfoliate with adzuki beans. He then ground some beans at home in a coffee grinder and mixed them with a bath gel. He now has to make sure those organic creations stand out among the 200 other brands Sephora sells. His idealistic mission depends on it. "Organic is the largest-growing segment of the cosmetics industry, and it's because wingnuts like me started creating relevance," Onysko says. BW

ANDY FREEBERG

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MONEY REPORT

WALK TO CHUCK?



Facing a tentatively positive outlook

Charles Schwab reported on Nov. 13 that client assets totaled $1.35 trillion at the end of October, a 16% increase from one year earlier. Shares of the firm trade at 18.79, but independent research firm Collins Stewart estimates the stock could reach 25 over the next 12 months, citing Schwab's "strong asset-gathering prowess." ¶ The Nov. 2 launch of the first Schwab-branded exchange-traded funds will likely attract new cash. The company is offering free online trading of the ETFs to its customers. That allows them to dollar-cost-average with the funds, sparing them the steep trading costs of investing at regular intervals in ETFs. ¶ Collins Stewart's price target is contingent on higher short-term interest rates: "The Fed keeping interest rates at current levels beyond 2010 is a risk." Credit Suisse analyst Howard Chen concurs, noting that near-zero short-term rates "continue to obscure the earnings power of the Schwab franchise." *–Tara Kalwarski*

MERGERS

ONE-STOP TECH GIANTS

On Nov. 11, Hewlett-Packard announced the $2.7 billion acquisition of networking company 3Com, the latest in a line of tech megamergers. It may also be one of the last, according to Canaccord Adams analyst Paul Mansky. He says the deals are a sign of an industry in transition. In the past, companies could choose one provider for networking needs and another for servers or storage. Now, big players are becoming one-stop shops.

$2.7 billion

Amount Hewlett-Packard paid for networking company 3Com

Many of the big tech players have already made deals, and Mansky argues that HP may not need to make another major acquisition soon. The same may be true for Oracle, which has its hands full with Sun Microsystems. Dell has needs, but not cash for a big deal.

On Nov. 12 the market seemed to acknowledge the new dynamic. Brocade Communications Systems' shares fell 12% on news of the HP deal; Juniper Networks and Riverbed Technologies suffered smaller losses. Investors seeking M&A targets may focus on smaller companies now, such as Extreme Networks. *–Ben Levisohn*

ERIC MILLETTE

THE MARKET

BULLISH SIGNS

At 1,110, the Standard & Poor's 500-stock index is up almost 23% for the year, and investors don't seem to be betting on a pullback. The S&P 500's short interest ratio—the number of shares borrowed and sold short, divided by a stock's average daily trading volume—dropped to 2.7 at the end of October, a low not seen since May, when the S&P 500 traded around 900.

Typically, the higher the ratio, the more investors believe prices will fall. "If the short interest gets smaller, it's a bullish signal," explains Hans R. Stoll, a finance professor at Vanderbilt University's Owen Graduate School of Management. Sectors with the lowest ratios include energy, materials, health care, and tech. Just six S&P 500 companies have ratios above 10: Rockwell Automation, Fastenal, Sears Holdings, Vulcan Materials, M&T Bank, and Waste Management.

The low overall ratio could mean we're at or near a peak. Over the past 80 years, the S&P 500 eked out annual gains of more than 20% about a quarter of the time. *–T.K.*

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A Brighter Idea From Philips

(FROM PAGE 065)

By Kerry Capell

Dutch conglomerate Philips is weathering the recession far better than it has previous downturns. In 2001 during the dot-com bust, Philips' shares fell 70% from their peak and took nearly four years to recover. This time, a slimmer Philips is bouncing back faster. After hitting a low of about 11 euros ($16.45) in March, Philips shares are now hovering closer to 19 euros ($28), a 30% gain from the start of the year.

Credit the improved resilience to Philips' new streamlined focus. Over the last decade the company has morphed from a high-volume electronic-components maker into a consumer-focused, brand-driven company, says London-based Sanford C. Bernstein senior analyst Martin Prozesky. By ditching its businesses in highly cyclical industries such as semiconductors, components, and phone headsets, Philips removed much of the extreme earnings volatility that had been its hallmark. It used the proceeds from those divestments to bolster its three core businesses: health care, consumer appliances and electronics, and lighting.

In the long run, the growth opportunities are immense. After all, the U.S. population, and that of many other developed nations, is aging, and health-care costs are rising. That is likely to increase demand for Philips' health-care products such as remote monitoring devices for stroke patients. And the growing interest in energy efficiency is expected to drive future growth of the next generation of lighting known as light-emitting diodes (LED), a major focus for Philips' lighting unit.

The downside? It will take time for those trends to translate into a further pickup in Philips' share price. In recent years the company kept investors satisfied with consistent dividends and a sizeable share buyback program. The dividend remains safe. But in the short term, all three of Philips' businesses face serious pressures.

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With LEDs, lighting faces the biggest technological innovation since the invention of the incandescent bulb, but amid the most difficult recession in recent memory. "The entire business model is shifting from one built around simply replacing bulbs to one in which lights are integrated into buildings, making it highly dependent on the construction cycle," says Prozesky.

A SHIFT UPSCALE

Consumer Lifestyle, Philips' appliance and consumer-electronics unit, also faces challenges. The company stopped making TVs worldwide, preferring to outsource manufacturing and concentrate on research and development and marketing. Now it's focusing on higher-end plasma and LED TVs as well as more upscale appliances including espresso makers and sonic toothbrushes. It is continuing to acquire niche companies, such as Avent, a mother and baby company, and Saeco, an Italian espresso maker. Still, analysts say there needs to be a dramatic pickup in premium discretionary spending before that business returns to growth.

While health care is expected to be a major driver of Philips' earnings and share price, the industry has its own set of thorny issues. A big one: U.S. health-care reform and what it will mean for insurance reimbursement policies for consumer health-care products. Also, governments and hospitals worldwide face financing constraints that could continue to crimp sales of medical equipment. And Philips' rivals General Electric and Siemens are making significant inroads into the home health-care market, which Philips used to dominate. "The intense focus on the health-care business since 2008's third quarter has acted as a drag on share price," says Peter Olofsen, an analyst at Kepler Capital Markets in Amsterdam.

After hitting bottom in 2009's second quarter, when sales plunged 19%, Philips' revenue growth is expected to remain negative for the remainder of 2009, according to analysts. In the third quarter, the decline slowed to 11%. Even so, Philips' shares have gained 30% so far this year, thanks in part to its aggressive cost-cutting measures. Now, in its leaner, more focused state, the company seems to have found the right business model. But "it will take a few more quarters before Philips returns to positive growth," says Olofsen. | BW |

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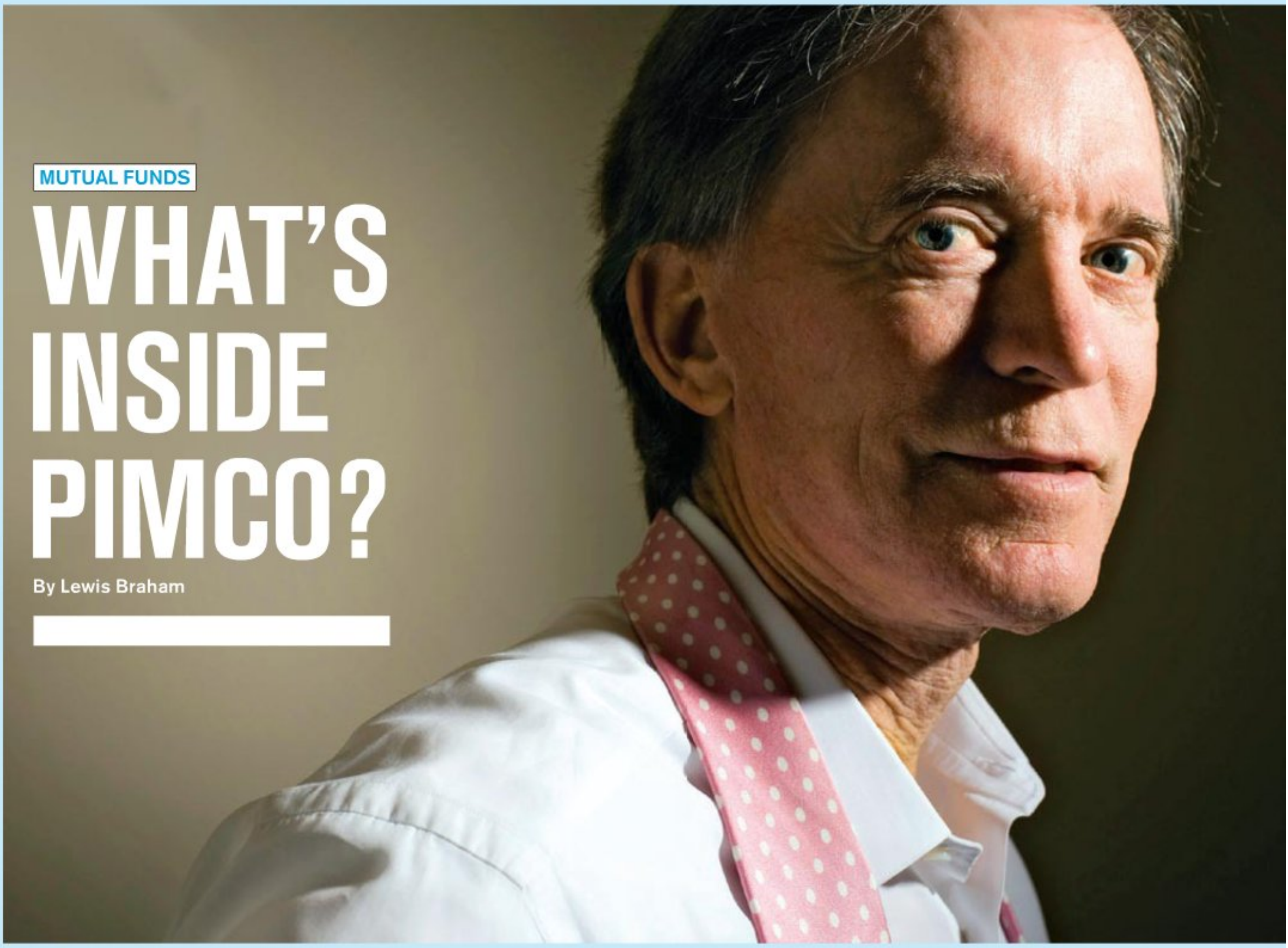
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MUTUAL FUNDS

WHAT'S INSIDE PIMCO?

By Lewis Braham

Pimco Total Return Fund's nearly $193 billion in total assets rival the gross domestic product of a small country—of Chile, Singapore, or the Philippines, say. It is the largest mutual fund ever, dwarfing its closest competitor, American Funds' Growth Fund of America, which has $145 billion.

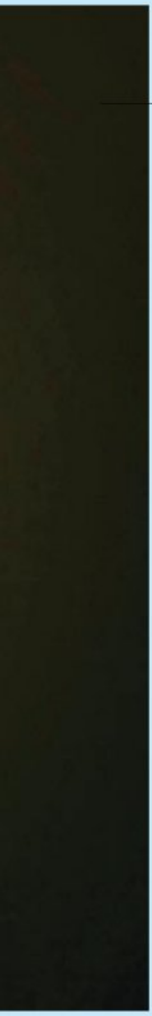
Despite manager Bill Gross' high-profile media presence and sage counsel on macroeconomic trends, the inner workings of his biggest fund remain largely a mystery. He has made public statements about favoring plain-vanilla mortgage bonds and, more recently, Treasury bonds, but his portfolio is complex. At 368 pages, the bond fund's June 30 report of its holdings is so opaque that many investment advisers have trouble understanding it. Many don't even try. "I don't look too much at what's in there," says financial planner Ray LeVitre of Net Worth Advisory Group in Midvale, Utah, which has upwards of $5 million in the fund. "That's why we hire Bill Gross—to take care of what's in there."

But what is in there? Gross was not available to talk about the fund. A Morningstar.com snapshot of Total Return's portfolio doesn't help much. What Pimco considers cash, Morningstar counts as bonds, so the portfolio is leveraged from the fund tracker's perspective. As of June 30, it listed 131.3% of the fund's assets as bonds. An additional 58% was cash on the long, or positive, side of its balance sheet. And 94.6% was in cash on the negative or short side—a short sale being an investment that profits when prices fall. About 8% was in "Other," which at Morningstar can include convertible bonds, preferred shares, or derivatives. Such a portfolio, as described, would be akin to a leveraged hedge fund's.

"SYNTHETIC" BONDS

Pimco Total Return is no hedge fund, but it does use some hedge fund techniques. "Leverage light is a hallmark Pimco tool," says Eric Jacobson, Morningstar's director of fixed income research. But "the people at Pimco call it 'bonds plus.'" It generally involves derivatives: The fund buys futures contracts or other derivatives to get exposure to bonds instead of buying bonds directly. It puts down a frac-

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Pimco's Gross is skilled at using derivatives to improve his fund's returns

tion of the full value of the futures contract, or what is called "notional value," as collateral. A contract providing $100 million in exposure to, say, mortgage bonds, might require only $5 million in margin collateral, creating a leveraged bet.

To counteract that leverage, a manager could put the $95 million difference in Treasury bills. That would create what's called a "synthetic bond," since T-bills are considered risk-free and so neutralize the effects of leverage. But Gross often buys other bonds. More than 100 pages of the holdings report are devoted to "net cash equivalents," a vast array of debt ranging from mortgage bonds to emerging-market debt. The bonds are labeled cash because they have durations of less than one year. Duration is a wonky term that signifies how sensitive a bond's value is to moves in interest rates. If a bond fund's duration is 1.5 years, it means the fund will decrease about 1.5% in value if interest rates rise 1%, and it will increase 1.5% if rates fall by the same amount. For Pimco, anything with a duration of less than 1.0 and a high credit rating is a "cash equivalent."

According to Jacobson, Morningstar uses a different and more restrictive definition of cash than Pimco. To be labeled cash in Morningstar's terms, bonds must have maturities (not just durations) of less than one year. Many of the bonds in Gross's cash-equivalent section have maturities several years out. Thus, to Morningstar, the fund is leveraged in bonds—that earlier 131% figure—though Pimco would call that extra 31% cash. Either way, Jacobson feels Gross has managed risks effectively. "Pimco does well investing in these bonds with a little longer maturities than cash to pick up a few extra [decimal] points in return," he says. And the 94.6% negative, or "short," cash position in the Morningstar report is cash Pimco theoretically owes on its derivative contracts as collateral if you calculate their full notional value. It is not really a short position.

Although the Total Return Fund's leverage is mild and common among bond funds, there are risks. Manager Jeffrey Gundlach of the $11 billion TCW Total Return Fund won't buy derivatives. "Many bond funds blew up last year that used derivative contracts, because instead of putting [collateral] money in T-bills, they invested in asset-backed securities they thought were the same as cash," he says. "Some of those securities fell more than 50%. Funds suffered massive losses because they were trying to goose returns by a few [decimal] points."

Gross, however, bested 95% of his peers over the past decade. (The percentage rises to 98% for the low-cost institutional share class.) The fund's derivative positions seem to have a big influence on performance. As of Sept. 30, a third of the fund's "duration exposure" was achieved through derivatives. Says Jacobson: "For the average manager, Pimco's level of derivative use would make me very concerned. What separates Pimco and Bill Gross is a demonstrated long-term track record of being really good at this type of investing."

Financial advisers tend to echo those sentiments. "I don't look at bond fund holdings but at how funds perform in different market conditions," says financial planner Jeff Feldman of Rochester Financial Services. "Derivatives are beyond my understanding, but if this fund were heavily leveraged, it would be more volatile than the average bond fund. But it isn't."

Of course, a basic axiom of investing is "know what you own." So what does it mean that the largest mutual fund in American history is tough to figure out? The fact is, no one seems to care as long as the performance is good. | BW |

—With Tara Kalwarski

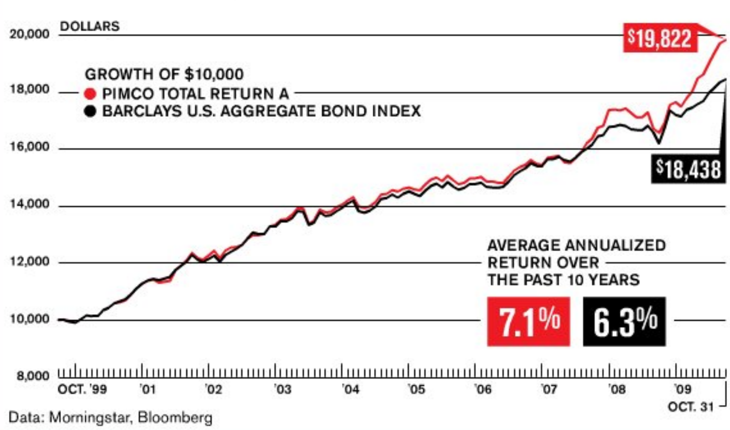
52%

Increase in total net assets of Pimco's Total Return Fund over the past year, to almost $193 billion. Over the same period, the fund returned 20%.*

*As of Oct. 31
Data: Morningstar

A LONG CLIMB

Total assets in Pimco Total Return have swelled more than 20% a year, on average, over the past decade. For much of that time the fund tracked its benchmark index. That began to change in mid-2007 as the financial crisis unfolded.



Data: Morningstar, Bloomberg

STEPHANIE DIANI/THE NEW YORK TIMES/REDUX; CHART BY DAVID FOSTER/BW

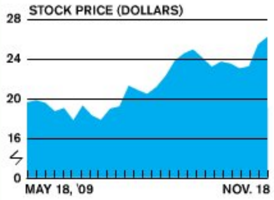
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A FRESH DEAL AT CABLEVISION?

Even before Cablevision Systems completes the spin-off of its Madison Square Garden (MSG) media, entertainment, and sports unit, the smart-money crowd is looking toward a possible sale of the company's remaining cable and telecom properties. "The spin-off paves the way for the sale of the rest of Cablevision," says Mark Boyar, president of Boyar Asset Management, which owns shares. He believes Cablevision (CVC) Chairman Charles Dolan, 83, who controls 70% of the voting stock, is ready to sell. His son, Cablevisison CEO James Dolan, is taking over the MSG operations, and Boyar says it's logical to expect that in such a situation the Dolans would unload the rest of the company. In the spin-off, investors get one MSG share for each Cablevision share they own. The fifth-largest cable-TV operator, Cablevision has holdings that include cable networks AMC, IFC, and Womens Entertainment.

CABLEVISION: VALUE TO UNLOCK



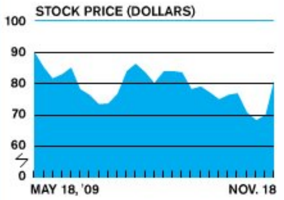
Data: Bloomberg

Christopher Marangi of investment firm Gabelli, which owns 6%, says the spin-off will unlock the value of the cable and telecom assets. Time Warner Cable and Comcast are apt to be interested in Cablevision's cable assets, says Marangi, who sees the shares, trading at 26.03 on Nov. 18, rising to 35. "Cablevision is well positioned to weather challenges," he says. Comcast declined comment.

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MONSANTO'S RECENT UPTICK



Data: Bloomberg

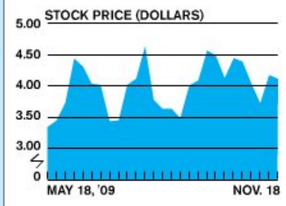
Seeds of a Rally For Monsanto

The world's No. 1 seed producer, Monsanto (MON), is playing catch-up: It missed the market rally, but that was O.K. with Keith Goddard, president of Capital Advisors Growth Fund, who scouts for blue-chip companies that stumble because of problems he sees as fixable.

Goddard bought in as Monsanto dropped to 67 a share on Oct. 30, down from 93 in May. True enough, it has recovered and is now at 80.01. The recession hurt Monsanto's sales, but the stock rallied when the company announced on Nov. 10 that its new premium SmartStax corn and Roundup Ready 2 soybean seeds will help boost seed earnings to as much as $7.5 billion in 2012.

Don Carson of UBS, rating Monsanto a buy, sees the stock hitting 94 in a year. He forecasts earnings of $3.15 a share in fiscal 2010 ending Aug. 31, $4.50 in 2011, and $5.63 in 2012, compared with 2009's $4.41.

PEAKS AND VALLEYS AT STEREOTAXIS



Data: Bloomberg

Computerized Aid In Heart Surgery

What draws attention to Stereotaxis (STXS) isn't just the odd name but its computerized system used in minimally invasive cardiac arrhythmia surgery. Its Niobe System uses computer screen images to steer catheters and guidewires through blood vessels and heart chambers.

Siemens and Philips are Stereotaxis' marketing partners, and Johnson & Johnson provides catheters for Niobe, which Stereotaxis sees becoming the standard in heart surgery. The stock, now at 4.12, down from 14 in 2007 (when sales were at $37 million vs. 2009's estimated $50.3 million), is a buy on an "anticipated ramp-up in new Niobe orders" in coming quarters, says Mimi Pham of Soleil Securities, who has a year's target of 7.

Tao Levy of Deutsche Bank, also bullish, says Niobe will benefit from an expected rise in hospitals' capital outlays. | BW |

BRAD TRENT; CHARTS BY DAVID FOSTER

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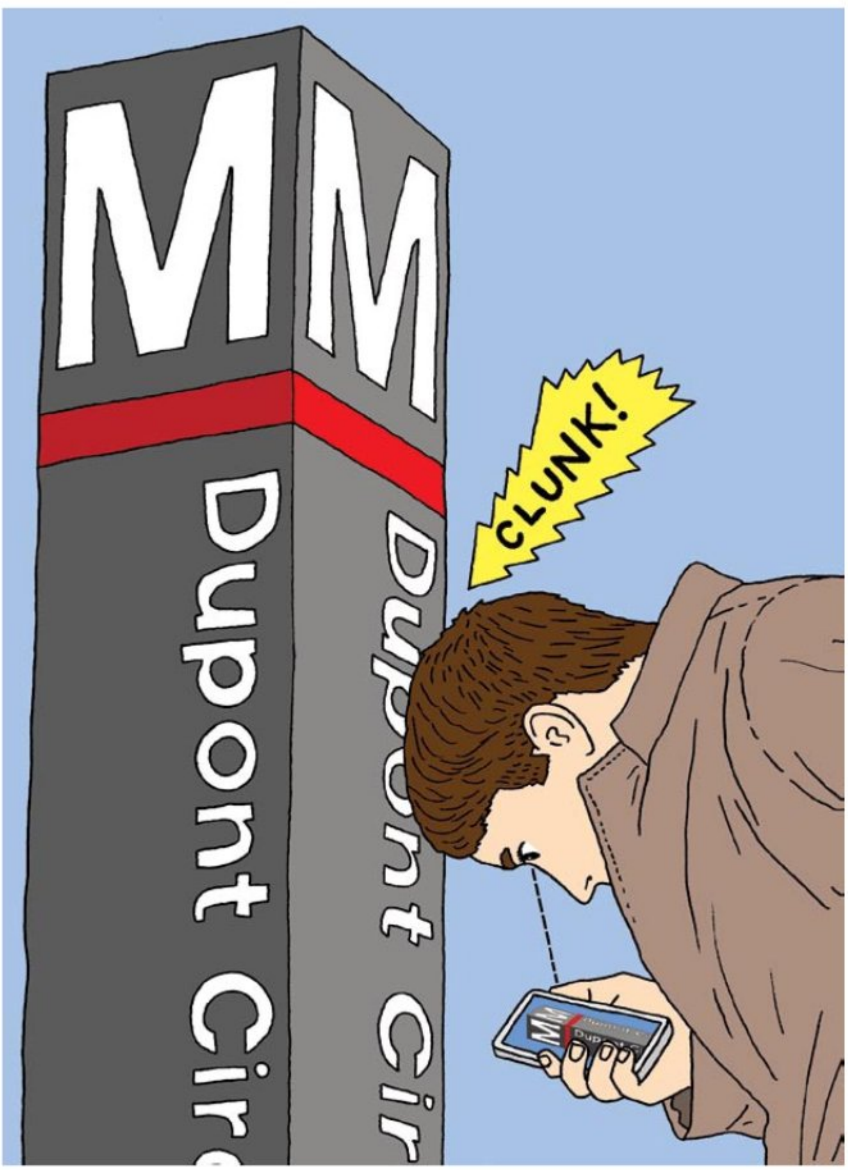
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TECH & YOU | STEPHEN H. WILDSTROM

Augmented Reality: Not That Real Yet

Why iPhone apps that act as a digital guidebook aren't quite ready for prime time





BRAD TRENT; ILLUSTRATION BY PETER ARKLE

While standing on the sidewalk in downtown Washington, I hold up my iPhone and slowly turn around, watching the camera image on the screen. As I rotate, a Washington Metro icon appears superimposed on the picture. Avoiding some curious stares, I follow the direction indicated by the icon until I reach a subway entrance.

The application I have just described is an example of augmented reality. This long-awaited technology combines a smartphone's ability to take pictures, pinpoint your location, and search online to put information about what the camera sees right on the screen. There are just two problems: As it exists today—mainly in the form of iPhone apps—the technology doesn't work all that well. And the cool stuff it can do today is often a step down from just using conventional mapping and search applications. Someday I may be able to walk down a street, point my phone at a building, and get guidebook information on what I am seeing, but that day seems to be a ways off.

Consider Presselite Development Studio's 99¢ Washington Metro app, one of the better augmented reality programs I have tried. For most people, I predict, the novelty of having the subway entrance location superimposed on a picture will wear off pretty

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HOW YOUR PHONE COULD AUGMENT YOUR WORLD



The camera in your smartphone snaps a photo of a building or other landmark



A GPS receiver in the phone determines your position—latitude and longitude



The phone's built-in compass reports the direction in which the device is pointing



A server associated with the app you're running analyzes these three inputs



The server superimposes relevant info over the image on your screen

quickly. If you are far enough away from the station to need instructions, you're probably better off using an old-fashioned map that can show you the best way to the station—e.g., turn right at the next corner and walk two blocks—rather than trying to follow an icon on the screen. Fortunately, an un-augmented map option is built into this app. On the other hand, if you are close enough for an augmented reality app to point to a picture of the entrance, well ... you could just look up and see it.

Pocket Universe from Craic Design ($2.99) is a different sort of augmented reality program. Point your iPhone camera at the night sky and the app gives you a star map of what you are seeing. I found it a bit hard to assess in Washington's extreme light pollution, which can make it hard to see the Big Dipper. While it wasn't accurate enough to find a specific star, the maps did give a good general idea of what you were looking at.

Augmented reality uses three technologies that are, or soon will be, ubiquitous on smartphones: a camera to generate the image, a GPS receiver to determine your location, and the newest addition, a compass to sense the direction in which the phone is pointed. In theory, a service should be able to take your latitude, longitude, and orientation and tell you exactly what you are looking at.

Alas, the data aren't nearly accurate enough for that. The receivers in phones don't get close to the theoretical GPS accuracy limit of one meter or so. A GPS fix that puts you somewhere within a 20-meter circle is adequate for car navigation and most other location-based services. But it's not good enough to tell exactly what building you are in front of as you walk down the street.

There's an even bigger conceptual problem with augmented reality as it is used today by a variety of search apps such as the Layar Reality Browser, Wikitude World Browser, or Presselite's Bionic Eye. They do a great job of guiding you to the nearest McDonald's, but only if it is somewhere in your line of sight. If the target is on the next block behind the building you're looking at, the information gets superimposed on the building in front of you, not the one to which you are being guided. Again, a conventional map is far more useful.

The technology will get better as the apps improve. Right now, you mainly see the warts. For example, Wikitude, a program that gives on-screen links to Wikipedia entries on objects around you, by default tries to show every point of interest within 100 miles. You can turn the range down to a mile, but even that produces a jumble of links in an attraction-filled place like D.C.

Augmented reality still feels like something that exists only because, technologically, it can. But behind the gimmickry, you see the possibility of mobile devices giving you real-time information on your immediate surroundings. With better location accuracy and some deeper thought given to the applications, "augmented" could live up to its meaning: something that adds to what we have. |BW|

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Don't Get Real, Get Realer

Interested in taking a deeper dive into the fast-evolving world of augmented reality? An article on the Web site HowStuffWorks.com not only details how augmented reality combines data and images but also gives some tantalizing suggestions on where the technology may be heading.



To read this article and others on the topic, go to **http://bx.businessweek.com/augmented-reality/reference/**

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The King of the Cloud

Salesforce.com CEO Marc Benioff's book is a fun, user-friendly guide for entrepreneurs and spectators

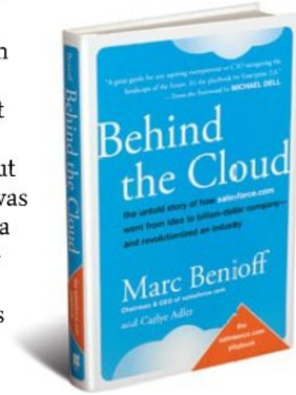
In the annals of technology, the latest phenomenon to get the attention of the industry's powerful hype machine is cloud computing. This is the idea that instead of people and companies owning and managing the computers and software that perform many of their everyday tasks, much of that technological scut work will be handled by others, out of sight, in the mists. People can tap the power of the cloud from any computer or gizmo that's attached to the Internet.

This new style of computing is generating a new kind of tech company. In his book *Behind the Cloud*, Salesforce.com Chief Executive Marc Benioff explains how he built one of those outfits—the world's most successful business-to-business cloud-computing company.

Salesforce.com sells an online service that helps businesses manage sales, customer service, and marketing functions. The 10-year-old San Francisco company topped $1 billion in revenues last fiscal year and is growing at 20% this year in spite of the recession. Benioff's reward for piloting this buster of the traditional business model is an 11% stake worth more than $800 million.

Behind the Cloud is both a how-we-did-it account and a how-to guide for entrepreneurs. (It's also a fun read for anybody who is fascinated with the world of startups.) In 111 "playbook" lessons, co-authors Benioff and freelance writer Carlye Adler take the reader through Salesforce.com's history and its ways of doing business. To Silicon Valley cognoscenti, many of the lessons will be familiar. But there's enough new here to make the volume well worth reading. And even when the advice is familiar, Benioff offers the same service his cloud service provides: He makes it user-friendly.

Benioff and a handful of colleagues started Salesforce.com in a tiny San Francisco apartment in 1999 with the idea of creating corporate software that would be as simple to use as Amazon.com. But while Salesforce.com was born in the dot-com era and Benioff has a reputation as a gonzo marketer, the company was not built on overblown promises like so many of its Internet brethren. That explains why it survived the dot-com bust and is thriving in spite of the Great Recession.



Behind the Cloud
by Marc Benioff and Carlye Adler; Josey-Bass; 278 pp.; $27.95

Salesforce.com has succeeded mainly because it assiduously caters to its customers. That's a requirement for cloud-computing companies: Since customers are buying a service rather than a product, they can walk away if they're not satisfied. Salesforce.com courts its customers in a long list of ways, from offering frequent seminars to intimate dinners at tony restaurants—including New York's tough-to-book Per Se.

Salesforce.com has succeeded because it assiduously caters to its customers and solicits and acts on their feedback

In cloud computing, client feedback is vital. One of Salesforce.com's most effective means of getting it is Play #61: Harness Customers' Ideas. The company created a Web site, IdeaExchange, where it introduces and solicits suggestions and has received more than a quarter of a million comments. It even invited customers to vote on a possible name change. Their vote: Stick with Salesforce.com.

Benioff doesn't always make the right business choices, but he learns from his mistakes. Play #56 addresses building trust. In late 2005 the company's computers crashed repeatedly. While engineers scrambled, Benioff wouldn't answer calls from reporters or customers. The blogosphere went nuts. "We realized that silence had been a terrible strategy," he writes. So thereafter he opted for total transparency—creating a Web site that offers up-to-the-second status reports. That gesture, plus fixing the problem behind the crashes, restored customers' trust.

Benioff could have written an entire book about marketing. This one is peppered with ideas that once seemed over the top but turned out to work. Early on, for example, Benioff hired actors to pose as protesters outside a user conference held by larger rival Siebel Systems. They chanted that traditional software was "obsolete" while a fake TV crew interviewed passersby. The stunt generated a lot of press—aka, free advertising.

Benioff still faces plenty of challenges. The cloud competition is just beginning. But *Behind the Cloud* paints a clear picture of what it takes to succeed in a world where many of the old rules no longer apply. |BW|

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EMPLOYEE—OR CONTRACTOR?

Do some businesses classify workers as contractors to deny them benefits and avoid paying employment taxes? Or is this "independent contractor" status simply a way for companies to render workers more productive and entrepreneurial? In response to our story about employment practices at FedEx ("They're Employees. No, They're Not," What's Next, Nov. 16), readers took up positions on both sides of the debate. –*Michael Orey*

Who can blame employers for wanting contractors instead of employees? Here are just a few of the things companies face today: unemployment taxes, retirement plan upkeep, 401(k) plan upkeep, medical plan upkeep, EEOC regulations, FICA tax, age-discrimination regulations, and so on. While some of these laws serve a good purpose, they also create a sense of entitlement with some employees and kill productivity.

Screen name: Contractor

C'mon—if I have to wear the FedEx uniform, start and end when they tell me to, deliver what and how they tell me to, I should be considered an employee. I deserve workers' compensation insurance, unemployment insurance, and coverage under the Federal Fair Labor Standards Act.

Screen name: Mike



All publicly held companies want to do business in a middle-class society, but fewer and fewer want to pay middle-class wages.

Screen name: DSW

Companies have been abusing this model for years. It should be federal law that contractors be hired as full-time employees after a year.

Screen name: Annoying Troll

TECHNOLOGY

KEYON COMMUNICATIONS MAKES ITS CASE

"A Broadband Player's Unorthodox Stock Play" (What's Next, Nov. 16) suggests that KeyOn Communications' stock performance is directly and solely related to bullish comments by Emerging Growth Research and other analysts. The article argues that EGR did not adequately disclose its ownership of KeyOn stock and implies that KeyOn somehow exerts control over EGR's disclosure practices. We do not. And we believe EGR properly disclosed its relationship with KeyOn. Not mentioned in the article are KeyOn's operational performance, balance sheet restructurings, and federal stimulus application submissions (plus a $3 million grant from the State of Illinois if we get the federal dollars).

To suggest that analysts are responsible for our stock rise casts a shadow on a vibrant seven-year-old company whose aim is to bring affordable broadband to rural and underserved markets across America's heartland.

Jonathan Snyder, CEO
KeyOn Communications
OMAHA

ENERGY

TO CONSERVE POWER, CHARGE MORE FOR IT

Regarding "Hasta La Vista, Power-Hungry TVs" (New Business, Nov. 9), about California's plan to ban flat-screen TV models that suck up a lot of electricity: The root cause of California's power-consumption problem is exposed in the article by the telling statistic that a 42-inch plasma TV uses just $4.50 worth of electricity a month. As long as power is too cheap to conserve, the only tool available to moderate demand is the blunt instrument of regulation.

Steve Scherer
ROUND ROCK, TEX.

SMALL BUSINESS

BANKS AREN'T PROVIDING ENOUGH LIFELINES

Loans backed by the Small Business Administration may be slightly easier to come by these days, as noted in "For Entrepreneurs, Credit Eases—a Bit" (What's Next, Nov. 2). But this isn't true for the America's Recovery Capital Loans, the $35,000 emergency loans intended for viable small businesses. They look good on paper, but try to find a participating SBA bank. I found only two on the California lender list, and they service only existing customers.

Kevin McNamee, Director
California Health Institute
WOODLAND HILLS, CALIF.

TOMER HANUKA

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This index gives the starting page for a story or feature with a significant reference to a company. Most subsidiaries are indexed under their own names.
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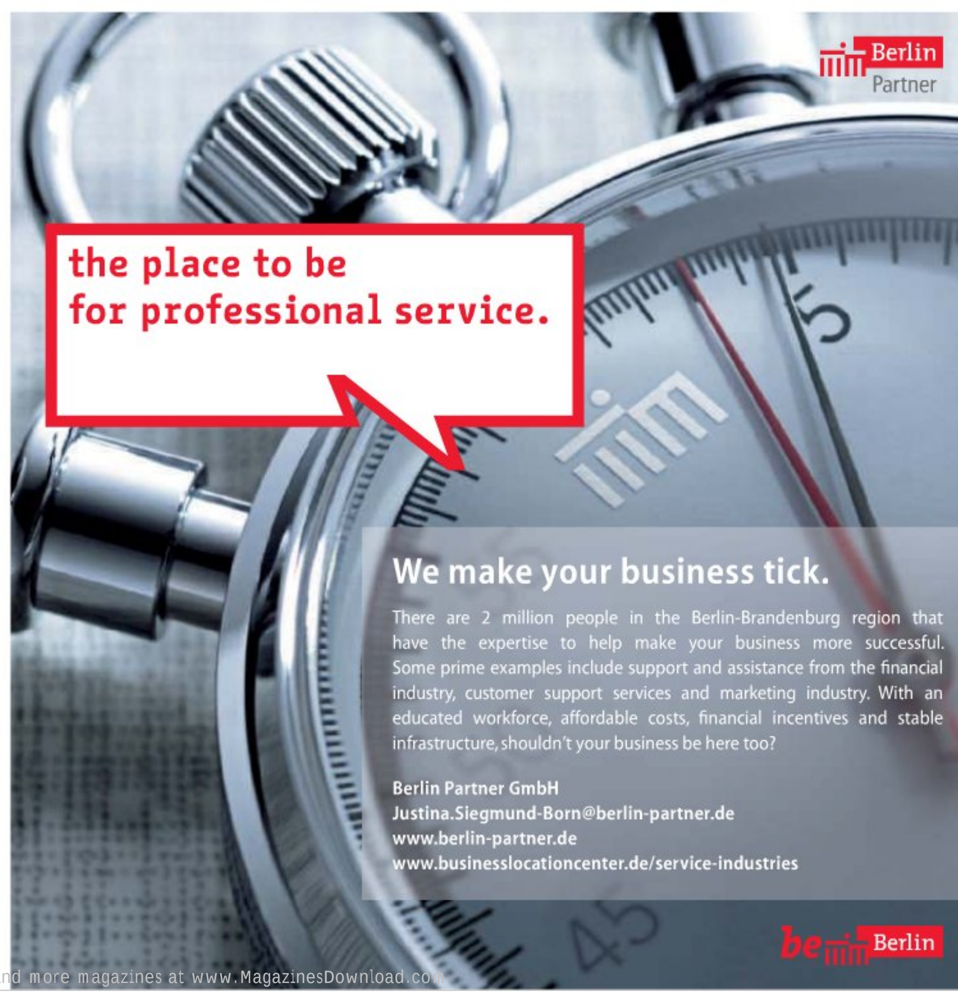
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 OUTSIDE SHOT | CARL SCHRAMM AND HAROLD BRADLEY



How Venture Capital Lost Its Way

The current focus on fees at VC funds promotes startup flipping, not nurturing

When people around the world try to explain the American system of entrepreneurship, they often point to venture capital. True enough, the venture capital ecosystem has nurtured startups that became household names—among them Apple, Cisco, Google, Microsoft, and Starbucks. For much of the 1990s and thereafter, venture capital was seen as the "secret sauce" of American entrepreneurship and an engine of job growth. In its heyday in 2000, VC investing reached an astonishing 1.1% of U.S. GDP.

But what if the prominence of venture capital—its branding as the essence of American innovation—turns out to be a phenomenon of the past?

New VC investment, already much lower than in the dot-com days of the 1990s, continues to fall. In 2009's third quarter, VC funds invested $4.8 billion in 637 companies, down 33% from $7.2 billion and 994 businesses a year earlier, according to a report by PricewaterhouseCoopers and the National Venture Capital Assn.



Meanwhile, two areas crucial to American progress cry out for capital-intensive investment: clean energy technology and biotech. And the VC industry isn't delivering it. (Info tech, which by now requires few capital investments, still accounts for the lion's share of those shrinking VC investments.)

What's to blame? We believe today's VC financing model—including the "2 and 20" charged by fund managers (a 2% annual management fee and 20% of all profits made from the IPOs or sales of companies in their portfolios)—no longer works. The industry is at an inflection point: Unless it applies some fresh thinking to the way it structures its funds, it will fail to get the next generation of startups off the ground.

A bit of history may help explain the problem. The modern VC industry started in a partnership format in the 1970s and '80s. Venture funds raised money mostly from wealthy individuals with enough patience for long-term, illiquid investments. Then, as now, investors committed their cash to a fund for 10 years. But because investors were scarce—and wanted to see success stories before plunking down more money—VC funds focused on identifying the right enterprises and sticking with them. Scarce capital made for good VC decisions.

Over the past decade, however, the typical venture fund investor changed. In the era of the financialization of everything, corporate and public pension funds got in the game. VC fund managers found these big investors could commit far more money on the same terms formerly extended to yesterday's high-net-worth individuals. This means a higher volume of continuing management fees. And for many VC managers, that means less focus on startup growth and more on raising funds.

Since institutional investors are under pressure to show short-term returns, VC funds are trying to keep them as investors by going for maximum liquidity, creating early payoffs via premature "exits" (selling some startups in their portfolios within three years, say). Instead of working to make their best startups strong and independent, they're "flipping" them, as private equity firms do with the troubled companies they buy.

In other words, today the traditional VC fee structure promotes haste in putting money to work rather than skill in developing new enterprises (or investing in such capital-intensive niches as cleantech and biotech). Long-term, it doesn't even pay. Over the past decade, an investor would have done better in the small-cap Russell 2000 index than in VC. Indeed, since 1997, returns for the average VC investor have been negative, after fees.

What can be done? In their role as fiduciaries, institutional VC investors should insist that management fees be tied to a budget—office rentals, salaries—not a fund's size. They should also demand a guaranteed percentage on their money, paid out before the VC manager enjoys that 20% share of profits. Both moves might cause VCs to hold on to their best enterprises longer.

So would skin in the game. Today, most VC funds derive a mere 1% to 2% of their totals from partner money. We at the Kauffman Foundation (which has a $1.8 billion endowment it uses to promote entrepreneurship) prefer VC partners who kick in 5% to 10% of their funds' value.

History attests to the importance of capital sources willing to fund unknown companies exploring uncertain innovations. The sooner we revitalize the stale relationship between VC funds and their investors, the sooner the industry can again support America's entrepreneurs. | BW |

Carl Schramm is president and Harold Bradley is chief investment officer at the Ewing Marion Kauffman Foundation, which promotes entrepreneurship.

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